EXEMPT FROM RECIPROCAL COMPENSATION REQUIREMENTS TELECOMMUNICATIONS TRAFFIC TO THE INTERNET

HEARING

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS, TRADE, AND CONSUMER PROTECTION

OF THE

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ThURSDAY, JUNE 22, 2000

HOUSE OF REPRESENTATIVES,
COMMITTEE ON COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS,
TRADE, AND CONSUMER PROTECTION,
Washington, DC.

The subcommittee met, pursuant to notice, at 11 a.m., in room 2123, Rayburn House Office Building, Hon. W.J. "Billy" Tauzin (chairman) presiding.

Members present: Representatives Tauzin, Oxley, Stearns, Gillmor, Deal, Largent, Shimkus, Pickering, Fossella, Ehrlich, Bliley, ex officio, Markey, Boucher, Rush, Luther, Sawyer, Green, McCarthy, and Dingell, ex officio.

Staff present: Justin Lilley, majority counsel; Cliff Riccio, legislative analyst; and Andy Levin, minority counsel.

Mr. TAUZIN. The subcommittee will please come to order. Good morning. I will ask our guests to take seats and to get comfortable. We have a good schedule today and we are going to have some interesting testimony.

We meet today to discuss an issue that, at first glance, seems as complex and as arcane as any telecommunications we have ever discussed here. But upon further review, the reciprocal compensation framework of section 251 of the Telecom Act of 1996 is really quite simple. The reciprocal compensation requirement simply mandates the telecommunications carriers compensate each other for the cost of handling and terminating local phone calls.

Ted, if you will put up the first billboard, here's how it works, or how it was intended to work.

It was intended to be reciprocal. It was intended such that when a CLEC customer calls a Bell customer, the CLEC company would then compensate the Bell company terminating the call on its network, basically delivering the call to the Bell company's end customer. Likewise, when the Bell company is similarly situated, the company would pay the CLEC with where the Bell company customers placed a call to a CLEC customer, who then terminates the call on the CLEC network. That all sounds simple enough.

Reciprocal compensation was designed in a situation where each is supposed to have a bunch of customers for whom the other company terminates the calls, completes the calls. It was a good idea, designed to work well.

But it worked well in a telephone world; when the Internet comes along, it complicates the picture in a way I think the Congress never foresaw back in 1996.

Ted, if you put up the second billboard.

With Internet traffic almost doubling every 100 days, many CLECs are terminating high volumes of calls which are bound for the Internet under the act; that is portrayed on this second billboard. In this situation, the caller's Internet service provider, the ISP, serves as a CLEC customer—and this is an important point—which does not return any of phone calls that it receives. So in the Internet world, when the ISP is a customer, there is no reciprocal call back. There is no world where customers are equally calling each other and companies are equally terminating or completing calls. All of the traffic goes one way.

In this situation, the caller's Internet service provider serves as the CLEC customer, and obviously doesn't call back. To the contrary, the ISP directs all the calls to the sites on the World Wide Web. As a result, reciprocal compensation is no longer there and compensation flows only one way, from the Bell company to the CLEC to the ISP. And, in fact, ISPs get part of the deal and have even referred to it in public statements as "kickbacks." The money is then used, by the ISPs own words, "above and beyond" the flat rate that the ISP bills to its customers. So the ISP is getting a nice little kickback on the deal. The CLEC is getting the benefit of one-way compensation.

Now, when you consider that reciprocal compensation charges are permitted charges on top of the fact that the average Internet session lasts 32 minutes in duration, you can see how the one-way flow of money adds up quickly. The average phone call lasts 4 or 5 minutes at most. A CLEC to any ISP will last on average 32 minutes, and customers are doubling every 100 days.

Just how much are Bell companies paying in reciprocal compensation? Well, I am told, in some cases it is more than they collect this revenue from their customers for the services they provide. In such a situation, then, they are left with no choice but to increase basic phone service, the phone service rates they must charge their customers, the consumers of America.

I want you to think about it. If a company pays out more than it takes in, it has to increase the amount it takes in from its own customers to survive. So it is paying out more money than it takes in, to the CLECs and ISPs, and has to collect more from its basic customers, those who support the basic telephone network.

Let me tell you how the situation can and is getting worse. Ted, if you put up the third chart. I am told that there are some CLECs out here who have recognized the tremendous cash-flow that reciprocal compensation can be as it pertains to the Internet-bound traffic. As a result, these CLECs have allegedly built businesses around collecting reciprocal compensation for Internet bound traffic with no intention of providing competitive local phone service to the customers as the 1996 act contemplates.

Let me say it again. In 1996, we contemplated CLECs coming into business to compete with local phone companies, to provide service to phone customers and to have active local competition. But now, because of reciprocal compensation, some CLECs have figured out that all they need do is become a “switch,” if you will, for traffic to the World Wide Web, and they can make money without ever becoming a local competitor to a local phone company.

These CLECs, I am told, are nothing more than shells with no residential customers to speak of, and they serve as alter egos of the ISPs. In fact, ISPs are meeting in seminars across America to learn how to become CLECs so they can take advantage of this situation.

I am waiting for the first one to call itself Bonnie&Clyde.com, because what we are talking about is the Information Highway robbery of the century. And if these CLECs are allowed to continue to do this, obviously the drain on the capital and the assets of our basic telephone networks is going to accelerate and consumers of America are going to take it very seriously.

Now, I understand there are witnesses here today who will take issue with the scenario I just described. Frankly, I am glad you came. If the information that has been reported to us is wrong, we would love a detailed account of how and why, particularly when we read stories about shell game CLECs setting up 93 phones in a horse barn and turning it on for 23 hours and 59 seconds each day in order to take advantage of reciprocal compensation, as though horses were going to somehow be an important player in the Internet world.

Furthermore, I want the CLECs and ISP witnesses here to explain why collecting reciprocal compensation for Internet-bound traffic does not provide their companies with an economic windfall far exceeding the amounts that are necessary for the recovery of their business costs.

As a Member of Congress, I appreciate the fact that all businesses need to recover the costs; recovery of costs is the very notion that inspired section 251(b)(5) of the 1996 act in the first place. But we are concerned that the dollar amounts passing from the incumbent local exchange carriers to the CLECs under the present reciprocal arrangements do not result in the over-recovery of costs, leading to unfair subsidization of one competitor by another. I am sure that we can all agree the act was never intended to have that result.

So I welcome our CLEC—our ISP witnesses to help us clear the air and set the record straight as they claim they are anxious to do.

In addition to discussing the nexus between reciprocal compensation requirements and certain business practices, we are also going to spend some time today discussing certain regulatory issues that surround the reciprocal compensation debate. As a matter of law, reciprocal compensation only applies to local calls, not to long distance calls and not to telecommunications traffic that is interstate in nature. CLECs contend that when an interstate user places a call to an ISP that isn’t a CLEC customer, that user is connecting to the ISP locally based server. As a result, the call is being terminated on the CLEC network, and as a result, the call is entirely a local call subject to the reciprocal compensation.

On the other hand, the incumbent carriers contend that because many Web sites are located across the country, the data passing to these sites, regardless of CLEC distribution functions, are clearly interstate, long distance in nature, and therefore, not subject to reciprocal compensation. The FCC, it appears, was once well on its way to agreeing with the incumbent carriers, but on February 26, 1999, the Commission released a reciprocal compensation declaratory ruling that the NPRM, which established that Internet-bound calls, are not local at all and therefore not subject to reciprocal compensation.

The FCC based its decision on so-called "end-to-end analysis" of Internet-bound calls. This analysis brought the FCC to the conclusion that because Internet-bound calls do not terminate at the ISP local server, but instead continue to one or more Internet Web sites located other States, such calls were long distance calls not subject to reciprocal compensation.

In a letter sent to me by Chairman Kennard, dated June 7, he states, "We found that ISP-bound calls are jurisdictionally mixed, largely interstate, not subject to section 251(b)(5) reciprocal compensation which applies to local traffic."

While as intriguing as that may be, I am inclined to agree with Chairman Kennard's statement; I think he is probably right in his observation. However, in the same declaratory ruling that the FCC characterized Internet-bound calls as interstate in nature, it did something quite peculiar, something we never thought in our wildest dreams that FCC would do, something that really makes its characterization of ISP-bound calls hollow and meaningless.

The FCC, out of bewilderment, ruled that State PUCs could require reciprocal compensation to be paid by the incumbent carriers for Internet-bound calls, despite its ruling that reciprocal compensation doesn't apply to these calls in the first place. That, of course, leaves us rather dumbfounded.

What is it all about? To me, this sounds like the Commission is saying, no, emphatically, but then turning around and saying what it really meant was yes. States go right ahead and impose reciprocal compensation, despite the fact that doing so allows to you regulate interstate commerce as if each of you was the FCC reincarnated. In the textbook example of how a hard-and-fast rule can be so readily negated or swallowed by an exception, based upon our experience, I know the FCC fights vigorously for its preemptive jurisdiction in this type of situation.

If any of you disagree, look at the battle we had in the local ratesetting in the utility boards case. I have never seen a case where federalism was more at issue.

So I am very anxious to hear today from Mr. Strickling of the FCC Common Carrier Bureau about the FCC's rationale here. Frankly, the letter I received from the chairman only raises additional questions concerning why the court of appeals remanded the FCC's order when it was challenged by Bell Atlantic back in March.

Mr. Strickling, I want to thank you in advance for joining us today, and ask you that you please help me understand why the FCC can say that while traffic is interstate that it can be wholly regulated by the States that assert the right to do so. I am interested in learning more about the Commission's thought process on this one.

With that having been said, I am looking forward to today's hearing. I think we are in for an interesting debate about an issue that is crucial to the future of phone service and of Internet service, and of the prices that are charged to consumers for both services.

We have assembled, I think, a very balanced panel. We want a complete record on it. We want to give the CLECs, the ISPs, a chance to answer these persons.

I thank you for coming, and I am sure that before we are through, we can somehow unravel this intricate web and figure out what is fair to consumers on both the Internet world and the telephone world.

The Chair will now yield to my friend from Massachusetts, the ranking minority member, Mr. Markey, for a statement.

Mr. MARKEY. Thank you, Mr. Chairman, very much; and I thank you very much for holding this hearing.

The issue that the subcommittee will receive testimony on today stems from the Telecommunications Act of 1996, and its success in creating competition in the local telecommunications marketplace. The act required telecommunications carriers to compensate each other for the cost of terminating traffic on each other's networks.

This was not a new concept. After the breakup of AT&T, we had to institute an access charge regime to deal equitably with the new relationships between AT&T and the Baby Bells, as well as with the emerging long distance competition. We also had intercarrier payments for wireless calls when wireless service developed.

In developing our policy for so-called "local loop" competition in the early 1990's, I was an advocate for an arrangement known as "bill and keep" as the best and most straightforward way of dealing with intercarrier compensation and local markets. Under "bill and keep," what we were essentially saying to telecommunications carriers is that everything will sort of come out in the wash as traffic flows between networks with identical payments or no payments, characterizing the compensation method. In crafting the 1994 Markey-Fields legislation, however, we settled upon a standard for compensation that was not explicitly "bill and keep," but rather a provision that called for just and reasonable compensation. Although the Markey-Fields bill and the companion Dingell-Brooks bill passed the House, the Senate failed to act, and the next Congress the relevant provision became known as reciprocal compensation and was enacted into law as part of the Telecom Act of 1996.

Since local telecommunications carriers have local networks that carry voice data and other telecommunications services, and the Telecom Act of 1996 obviously encompassed promoting competition for all of these services, reciprocal compensation agreements developed among carriers in the aftermath of the act, which are affected by the rapid emergence of the Internet.

Telephone traffic involving Internet service providers is largely characterized by the fact that the flow of traffic is overwhelmingly in one direction. The telecommunications carrier who obtained an ISP as a customer, therefore, could count on network traffic flowing onto its network and directed to the ISP. This flow of traffic to the ISP in the local market obviously affects the compensation to the carrier serving that ISP.

How much money? The fact that we are having a hearing on this marketplace phenomenon reflects the fact that there is a significant amount of money involved.

There is no question that innovation challenges telecommunications marketplace participants. But it also presents difficult policy questions for lawmakers and regulators.

Issues revolving around local telecommunications competition, such as reciprocal compensation or enhanced service provider access charges, Internet telephony or even plain access charges are all difficult issues and will be with us for some time. For example, we have had access charges in place for years, and policymakers must routinely revisit the issue and investigate whether charges are appropriate, whether they should apply to ISPs, ascertain if such charges are in fact coming down or if access charge reductions are being flowed through to end-users in the form of rate reductions.

In delving into these telecommunications issues, we must be mindful to ascertain whether the remedies to any current imbalances exist in the current marketplace with State regulators, or with the FCC; or finally, if Congress needs to intervene.

I believe it is important to address these issues in a consistent way carefully balancing the interrelated policy implications and ending uncertainty for marketplace participants. I look forward to today's excellent panel that you have assembled, Mr. Chairman.

I yield back the balance of my time.

Mr. TAUZIN. Thank you very much.

The Chair is now pleased to recognize the chairman of the full committee, the gentleman from Richmond, Virginia, the cosponsor of H.R. 4445, along with Mr. Dingell and Mr. Boucher and I. Anytime Mr. Bliley gets together on a bill on telephones, you have got to figure there is a real problem out there.

I want to welcome my friend.

Chairman BLILEY. Thank you, Mr. Chairman, for holding this hearing on the Reciprocal Compensation Adjustment Act of 2000.

The cornerstone of the 1996 act was bringing competition to local telephone markets. This committee carefully crafted those provisions to ensure that consumers would have the same choice and innovation in local services that they now have in all other telecommunications markets. As a component of bringing competition to the local loop, we provided a mechanism for carriers to compensate each other for the exchange of local traffic.

Congress and the FCC have been enabling intercarrier competition since 1984 in the market for interstate access. Long distance carriers they may access charge—pay access charges to local phone companies when they exchange traffic.Congress also ensured that wire line carriers are compensated for terminating calls that originate on wireless networks.

My colleagues will recall that we considered the idea of "bill and keep," a concept which would essentially have barred compensation for the exchange of local traffic. But in the end, we opted for requiring reciprocal compensation, in part because the local phone companies argued that "bill and keep" would be unfair. But here we are, 4 years later, and the local phone companies now think some forms of intercarrier compensation may not be such a good idea after all.

But what is even more ironic is that I find myself in general agreement with them.

As my colleagues know, I have fought long and hard for the laws of reducing access charges, which is just another form of intercarrier compensation. While the recent calls proposal helps matters, access charges will remain too high in my view, and I therefore look forward to further reductions. But in the meantime, access charges will continue to tax consumers and distort competition.

I raise the issue of inflated access charges because this committee must be vigilant that the same pricing distortions do not grab hold of the local market, which is struggling enough as it is to become competitive.

This legislation is a good starting point for this committee to debate this important issue. It is equally important that the FCC insert itself in this debate as well. I note that the court of appeals remanded their most recent ruling on this issue last February. Yet the FCC has yet to take a single step toward resolving the matter. The committee should get answers this morning from the FCC witness as to why this is the case. We should also make sure that the FCC will meet our September 30 deadline for completing this matter.

Mr. Chairman, I look forward to the testimony of all the witnesses this morning. And I look forward to working with you on this issue as we move forward.

Thank you, Mr. Chairman, and I yield back the balance of my time.

Mr. TAUZIN. Thank you, Mr. Chairman.

The Chair is now please to welcome and recognize the other cosponsor of H.R. 4445, my friend the ranking minority member of the full committee, Mr. Dingell.

Mr. Dingell.

Mr. DINGELL. Mr. Chairman, I thank you.

I, first, commend you for holding this hearing today on H.R. 4445, a bipartisan bill which is introduced along with Chairman Bliley, Congressman Boucher, and myself. And I am pleased that you have taken this leadership, both as a sponsor and in convening this hearing. If anyone ever needs to find an example of the law of unintended consequences at work, he or she needs to look no further than the reciprocal compensation provision of the Telecom Act of 1996.

Your comments with regard to the horse barn are a matter of real concern. The best that it could be described as is a scam. The events that have been associated with this have brought to my mind and attention other things which can also be called scams, which are about to occur.

On its face, the reciprocal compensation provision seems innocuous enough. In fact, it appears to make perfectly good sense. If two local telephone companies compete in a market then each must compensate the other when sending calls to the other's customers on the other's network. It is a perfectly legitimate cost settlement basis that has been used historically in many different business contexts.

In an unregulated market, when businesses agree to settle costs this way, any unforeseen consequences may be remedied rather easily through private contracting. And if one party to the contract is engaged in an abusive practice to gain an unfair advantage, the other may have a legal claim that can be pursued in court to obtain appropriate redress.

But in a regulated market, particularly when one exists in which the Congress has explicitly legislated a duty upon a party, the remedies for unforeseen consequences are quite different and, regrettably, more difficult and time-consuming to accomplish.

It is not simply a matter of renegotiating a contract or taking the offending party to court. The law has to be changed to correct the inequity. And it may only be done prospectively, as opposed to retrospectively, to correct the wrong about which a complaint is very valid indeed. The longer it takes to accomplish the fix, the more economic harm accrues to the parties. And there is no redress available for past losses. That is why the situation before us must be remedied, and the sooner the better.

Reciprocal compensation was intended to be just that, reciprocal. Traffic that is carried exclusively in one direction, as is the case for dial-up Internet connections, should not be subject to the same inter-carrier compensation scheme as calls that flow in both directions between two networks. This is only common sense. To do otherwise leads to inefficient, uneconomic behavior, where the costs are borne by the parties who receive no benefit. And worse, it attracts, as this situation before us, a host of scams where swindlers can profit from innocent parties with complete impunity.

The time for action, then, is now. Internet traffic is increasing at an extraordinary pace. Not surprising, too, is the number of competitive LECs that primarily serve ISPs. Taking advantage of this one-way reciprocal compensation loophole is indeed a lucrative business. Nearly $2 billion will flow this year from traditional telephone companies to those companies serving mainly ISPs. Scott Cleland, a leading telecommunications analyst with Legg Mason, described this windfall in the following way, and I now quote:

"No other place in the telecom sector can companies reap a 4,000 percent arbitrage for minimal, value-added service." But Mr. Cleland warned investors in the same article that that loophole was, a "gravy train running out of track." The warning came nearly 2 years ago. Unfortunately, the remaining track was longer than thought by Mr. Cleland. But I hope and I believe the end is in sight; it certainly should be.

Mr. Chairman, I thank you for your leadership on this matter. I thank my colleagues for joining me in cosponsoring this matter. I urge our colleagues to listen to the testimony closely and then examine their conscience as to the justice and justification for the practices that we will hear described today.

I thank you, Mr. Chairman.

Mr. TAUZIN. I thank the gentleman.

The Chair now recognizes the vice chairman of the subcommittee, the gentleman from Ohio, Mr. Oxley.

Mr. OXLEY. Thank you, Mr. Chairman. While the issue may be new, it somehow has a familiar ring to it. The battle lines certainly seem to be forming along well-established boundaries.

I think it is safe to say that the issue before us is an example of an unintended consequence of the 1996 act. It shows the unpredictable nature of technology and the market. As rapidly as things are evolving, the wonder is there aren't a lot more such circumstances around.

The question before us is whether the problem, such as it is, requires a legislative solution. There certainly is an imbalance, but is it one that the industry and the market won't work out over time? That is really the question.

Amending the act is not something that should be undertaken lightly. If there is a true marketplace distortion resulting from our work, especially if it is a large discriminatory distortion, certainly we should fix it; but there is a cautionary tale here. If we could not accurately predict what the 2000 market would look like when we put the finishing touches on the act in 1996, what are the chances that we will accurately predict the 2004 marketplace today? This committee is pretty good, but not that good.

I want to commend our former colleague and friend, Tom Tauke, and one of the architects of the 1996 act, for being with us.

And with that, I yield back.

Mr. TAUZIN. The Chair thanks the gentleman. The Chair recognizes the gentleman from Virginia another cosponsor of the legislation and an active participant in telephone and telecom reform, Mr. Boucher.

Mr. BOUCHER. Thank you, Mr. Chairman. I want to commend you for introducing H.R. 4445 and for conducting the hearing today which focuses on a practice that is contrary to the public interest and which calls for the remedy that your legislation provides.

During this subcommittee's hearing on May 3, when we were addressing the extension of the Internet tax moratorium, I urged that the subject of reciprocal compensation and the abuse that it entails when traffic that is destined for the Internet is delivered by one local exchange carrier to a second local exchange carrier in the community has as its customer an Internet access provider be placed on this committee's agenda. H.R. 4445 is a complete response to this need and to that request; and I am pleased to be one of the cosponsors of the measure.

The abuses to which the bill responds are real. While the reciprocal compensation arrangement, as the chairman indicated, works well with regard to traditional telephone traffic, it operates in a manner that is both illogical and inequitable when applied to traffic that is data based and is destined for the Internet. In this context, it has become a one-way arrangement with essentially no reciprocal nature.

In many instances, CLECs have gone into the business just for the purpose of receiving Internet access providers so that they can receive reciprocal compensation payments. Since no calls ever originate on their networks, they make no payments in return.

In other instances, the primary customers of the CLEC are Internet providers with the result that while some calls do, in fact, originate on the CLEC networks, the balance of reciprocal compensation payments greatly favors the CLEC. The prevalence of these arrangements is well illustrated by the experience of one large incumbent local exchange carrier which reports that, system-wide, it makes $20 in payments to the CLEC within its system as compared to every $1 in payment that the CLEC made to the incumbent local exchange carrier. If traditional telephone traffic were involved, you would expect the payments to be roughly equal in nature. These are largely CLECs that are serving ISPs and receiving a huge amount of reciprocal compensation flowing essentially one way only.

I should mention that in the most egregious cases the ISPs themselves have qualified as CLECs of which they are the only customer, and they receive payment from the ILEC when their own customers' Internet traffic is brought to their facilities. They are being paid for the privilege of receiving their own customers' traffic. It is kind of hard to imagine a scam that is much greater than that.

This distorted application of reciprocal compensation causes demonstrable public harm. Users of traditional telephone services are today subsidizing the users of enhanced services. This arrangement is contrary to our long-standing tradition in this Nation of having a set of public policies designed to keep basic local telephone service affordable; and in the past, if we have had any subsidy, it has flown from the users of advanced services to the users of basic telephone service. This use of reciprocal compensation reverses that long tradition.

Second, the arrangement thwarts one of the primary purposes of the 1996 Telecommunications Act because it discourages CLECs from making facilities-based investments and extending their services to residential customers with their local exchange service. They actually receive more revenue from the reciprocal compensation payment than they would receive if they had that particular customer as a local telephone customer. So the last thing they want is to extend local telephone service on a competitive basis to the people with respect to whom they are getting reciprocal compensation payments today.

As Internet usage grows and today's $2 billion problem becomes, next year, a $4 billion problem and as Internet growth pushes that total of disingenuous reciprocal compensation payments even higher, the local telephone companies are going to have to recover the cost of these payments through higher telephone bills, through reduced services or by some other means. The passage of the bill that we have before us would prevent that result. It would successfully address the other concerns that I have raised this morning; and Mr. Chairman, I very much hope that this subcommittee can report the measure at its earliest opportunity.

I want to commend you for introducing the bill. I want to commend the other cosponsors and, along with you, I look forward to today's testimony.

Mr. TAUZIN. I thank my friend and I thank him for his extraordinarily long held interest in this reform.

And the Chair now yields to the gentleman from Illinois, Mr. Shimkus, for an opening statement.

Mr. SHIMKUS. Thank you, Mr. Chairman. I will be brief as I think most of my colleagues already have fully explained a lot of the concerns.

I am one to look at it from two points of view. And I will be observing the question and answers. What is this going to do to the consumer and the price both currently and if this law is enacted? Because of the issue of, although current reports say that if the digital divide is decreasing, everybody's got computers, we want to make sure that it is not only that the hardware and the software is accessible to those, but also the ability to interconnect—so cost.

And the other issue will be the smallest of the small companies of which I have a couple in my district. Because there are some real costs there, and there is some real switching, real lines, and some real charges that have to be paid for use of services, I understand that there may be problems out there. I am not a cosponsor yet, but I look forward to working with the chairman and committee members to address these issues and hopefully find a way to protect consumers.

With that, I yield back my time.

Mr. TAUZIN. The Chair yields to the gentleman from Texas, Mr. Green, for an opening statement.

Mr. GREEN. Thank you, Mr. Chairman, for holding this important hearing.

The issue of reciprocal compensation is very complex and it affects every consumer. Reciprocal compensation is originally designed to offset the costs of terminating phone calls between different carriers. I am not going to bore the subcommittee, describing the technical workings of the billing process; what I do stress is, reciprocal compensation in its present form is not working. However, I am not completely convinced that H.R. 4445 is the answer.

Do I support ISPs pretending to be to be CLECs just to collect reciprocal compensation? Obviously not. But does there need to be some minimal level of compensation for those that terminate Internet traffic? I am not sure. We spend a significant amount of time trying to enhance the availability of Internet to our constituents, and there is a significant amount of debate whether reciprocal compensation is helping or hurting the digital divide.

Mr. Chairman, I need to be convinced that there is a better solution than maybe what is before the committee today, and I look forward to the testimony and I hope both the benefits and drawbacks of the reciprocal compensation has on Internet accessibility to be thoroughly discussed.

Thank you, Mr. Chairman.

Mr. TAUZIN. The Chair recognizes the gentleman from Mississippi, Mr. Pickering.

Mr. PICKERING. Thank you, Mr. Chairman. I thank you for holding this hearing today.

As my friend from Illinois said, we do need to look first at, how does this affect the consumers? Second, how does this affect competition? Are there legitimate issues of arbitrage that we can effectively and narrowly address? And the last question is, what is the best way to resolve these? Can we maintain the contractual arrangements and methods with State help and oversight? Is that the right jurisdiction or do we need a Federal fix through legislation for this issue?

I look forward to the panel's testimony. And again we do need to look at the market, as competition is emerging, to do nothing that would impede or serve as a hindrance to the developments of the markets evolving. If there are legitimate issues, we need to address them, but do it as narrowly as possible.

I look forward to the rest of the hearing and, again, thank you for your leadership on this issue.

Mr. TAUZIN. The Chair now recognizes the gentleman from Oklahoma, Mr. Largent, for an opening statement.

Mr. LARGENT. Thank you, Mr. Chairman. I want to thank you for holding this hearing on H.R. 4445, which would exempt reciprocal compensation requirements for the telecommunications traffic to the Internet.

In 1996, when the act was first being implemented, Bell Atlantic submitted comments to the FCC, "The most blatant example of a plea for a government handout comes from those parties who urge the Commission to adopt a reciprocal compensation price of zero. A regulatory mandated price of zero by any name would violate the 1996 act, the Constitution, and sound economic principles."

That was submitted to the FCC by Bell Atlantic; 4 years later the Bell companies have found that reciprocal compensation as it applies to Internet traffic is not such a great deal for them, and that it should be viewed as an unintended consequence and therefore be corrected by the legislation before us today.

Mr. Chairman, if CLECs are being created that are essentially ISPs and their only purpose for being is to collect reciprocal compensation to gain the system, created by section 251, then we need to address that problem in a selectively targeted manner. However, H.R. 4445 goes well beyond that rifle-shot approach by eliminating reciprocal compensation for all Internet traffic to all CLECs.

My concern is that if ISPs are no longer eligible for reciprocal compensation, or calls to ISPs are no longer eligible for reciprocal compensation, CLECs will have two choices, neither of which is positive. CLECs may have to raise the rates they charge to ISPs, which in turn will be passed along to our constituents and the customer. The other option is that CLECs may have to go out of business. It is important to note that many of these reciprocal compensation contracts are beginning to expire. Most were made for 3-year terms and are coming to an end.

The incumbent local exchange carriers are not going to make the same mistake twice. In all likelihood, the new negotiated or arbitrated reciprocal compensation rates for Internet traffic will be substantially less than they are today.

Last month, I joined with you, Mr. Chairman, and several members of this subcommittee and sent a letter to Chairman Kennard requesting that the Commission complete its action on this issue in a fair and economically efficient manner by September 30 of this year. I would hope that the FCC will abide by that request.

Mr. Chairman, thank you for holding this important hearing. I look forward to hearing from all of our witnesses, and I yield back.

Mr. TAUZIN. I thank my friend.

I might add that I think 50 members of this committee all but two members, Democrats and Republicans, cosigned that letter to the FCC. I thank the gentleman.

The Chair recognizes the gentleman from Ohio, Mr. Sawyer, for an opening statement.

Mr. SAWYER. Thank you, Mr. Chairman. It is good to see our old colleague, Tom Tauke, here. It has been some time, and I am glad to know he is still in there and kicking.

By way of summary, it seems to me we are dealing with several dimensions here and that the actual costs that are incurred are not clear to me. I don't understand what is driving the costs at their core, which it seems to me is very important to understand if we are to come to a conclusion about the questions that are at stake in this hearing today.

With that, I probably revealed more about my ignorance than I cared to, so with that, I will stop talking and start listening.

Mr. TAUZIN. Mr. Stearns is recognized.

Mr. STEARNS. Thank you, Mr. Chairman.

I, like Mr. Sawyer, am a little bit nonplussed by some of the issues here. I don't believe the issue is clear-cut, and I believe that both sides of the industry have legitimate concerns. CLECs argue that reciprocal compensation serves as a cost-based payment allowing them to recover costs for terminating incumbent calls.

Additionally, they argue that CLECs have been successful in gaining ISP business due to superior services. Furthermore, the CLECs are quick to point out that elimination of reciprocal compensation will mean they will have to raise their rates for users; and I think that is something, Mr. Chairman, we have to put in perspective.

The incumbent phone companies, on the other hand, argue that since the transmission originated by a user ultimately terminates at the source on the Internet, the use is excessive, accessing communications between an end user and an ISP, and is interstate and thus not subject to reciprocal compensation payments.

Additionally, the incumbents argue that ISP-bound traffic is basically all one way; reciprocal compensation is anything but reciprocal and is outside the scope of the intent of the Telecommunications Act. So, I mean, you have, Mr. Chairman, both sides of the argument that are presented.

So I look forward to this debate and compliment you on this hearing and ask that my entire statement be made part of the record.

Mr. TAUZIN. The gentleman asks unanimous consent that his entire statement be made part of the record. Without objection, it is ordered.

[The prepared statement of Hon. Cliff Stearns follows:]

PREPARED STATEMENT OF HON. CLIFF STEARNS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. Chairman, thank you for holding this important hearing on H.R. 4445, the Reciprocal Compensation Adjustment Act of 2000. I would also like to thank the witnesses here this morning. The purpose of this hearing is to examine the issue of ISP-bound traffic and whether federal legislation is needed to address billing and accounting of such traffic. Like many issues before this committee, this is a matter in which our witnesses all have valid points and concerns.

The goal of the 1996 Telecommunications Act was to introduce competition in the local telephone market. In order to do so, one of the many issues that was addressed was reciprocal compensation, the settlement mechanism for when one local network hands traffic on to another. Under provisions of section 251(b)(5) of the Act, local exchange carriers are required to estimate reciprocal compensation for the transportation and termination of telecommunications. Under this billing and accounting mechanism, the network that originates a local call pays a fee to the network that terminates the local call and payments flow in the direction of network traffic.

While the Federal Communications Communication, in its Reciprocal Compensation Order, ruled that telecommunications between the user and the ISP is interstate and not subject to reciprocal compensation, it left state PUC rulings requiring reciprocal compensation intact. Earlier this year, a U.S. District Court vacated the FCC's rules on reciprocal compensation, ruling the FCC had not adequately explained why calls to ISPs were interstate, rather than intrastate, in nature.

While the FCC reevaluates the dynamics of reciprocal compensation. Competitive Local Exchange Companies (CLECs) are aggressively signing up ISPs as customers. Since an ISP's telephone network doesn't typically make any outbound telephone calls, there is no compensation that flows to the incumbent carrier for origination and termination of traffic by the ISP's carrier, the CLEC.

As I stated earlier, I believe this is an issue which is far from clear cut and believe both sides of the industry have legitimate concerns. CLECs argue that reciprocal compensation serves as a cost-based payment, allowing them to recover costs for terminating incumbents' calls. Additionally, they argue that CLECs have been successful in gaining ISP business due to superior service. Furthermore, the CLECs are quick to point out that elimination of reciprocal compensation will mean they will have to raise rates for users.

The incumbent phone companies, on the other hand, argue since the transmission originated by a user ultimately terminates at the source on the Internet the user is accessing, communication between an end user and an ISP is interstate, and thus, not subject to reciprocal compensation payments. Additionally, the incumbents argue that since ISP-bound traffic is practically all one way, reciprocal compensation is anything but reciprocal, and is outside the scope of the intentions of the Telecommunications Act.

On top of it, incumbents cite instances of CLECs now "gaming" reciprocal compensation in such a way as to aggressively sign-up customers that only terminate traffic, there by allowing them to collect millions of dollars from the incumbents. Furthermore, in some instances, reciprocal compensation has opened the door for fraud and abuse. Earlier this year, the North Carolina Utilities Commission ruled that BellSouth would not have to pay reciprocal compensation to US LEC of North Carolina, because the CLEC had deliberately manipulated the routing of calls "for the purpose of generating reciprocal compensation." One of the commissioners, in fact, described the actions of US LEC as "fraudulent, unfair and deceptive and perhaps even criminal."

As Congress and the FCC examine reciprocal compensation, it is imperative to be mindful of the original intent of this billing and accounting mechanism, to reimburse competitors for the costs of terminating traffic. While there certainly are legitimate business models centered around one way-traffic schemes, effective telecommunications policy needs to recognize and distinguish, these legitimate systems from ones created merely to manipulate the system. At the end of the day, as in any accounting model, if there is no off-setting model, then it is not reciprocal.

I look forward to a lively debate and listening to both sides of the industry on this important matter. Once again, thank you for holding this hearing Mr. Chairman.

Mr. TAUZIN. The Chair will ask general, unanimous consent that all members' written statements and all witnesses' written statements be made part of the records. Without objection, so ordered.

[Additional statement submitted for the record follows:]

PREPARED STATEMENT OF HON. BARBARA CUBIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WYOMING

Thank you, Mr. Chairman, for holding this important legislative hearing on your bill to establish a separate reciprocal compensation rule regarding ISP-bound traffic.

I want to begin by saying I think the authors of the 1996 Telecommunications Act had it right when they allowed local and long distance telephone companies to compensate each other for carrying the others' telephone traffic.

These types of charges were implicitly negotiated between—and obviously accepted by—the incumbent and competitive local exchange carriers and subsequently put forth in the '96 Act.

I do, however, have a problem with Internet Service Providers (ISPs) posing as Competitive Local Exchange Carriers (CLECs) to receive a slice of the reciprocal compensation pie even though they are not providing—and have no intention of providing—competition to the incumbent local telephone company.

These bogus CLECs should not be allowed to operate for the sole purpose of milking the customers of incumbent telephone companies—and that's exactly what ends up happening. The incumbent local exchange carriers (ILECs) are having to charge more from their customers to cover these costs.

That type of activity, however, can be easily avoided since these are negotiated agreements with the ILECs. In addition, if CLECs are not providing adequate services, they cannot become certified by the state's Public Utility Commission.

We passed—and I enthusiastically supported—the Telecommunications Act of 1996 to bring more competition into all areas of the United States, provide telephone customers with lower costs, and bring more advanced services to all Americans.

Mr. Chairman, I'm proud of the work we've done to ensure that competition reaches all comers of this country.

To my knowledge there are about 27 CLECs operating in Wyoming. That's a significant number of Wyoming telephone customers being served by companies that probably weren't around before 1996.

I'm worried, however, about the thought of pulling the reciprocal compensation rug out from under the competitive telephone industry and how that could adversely affect the rollout of both telephone and advanced services, especially in rural areas.

These types of Congressional actions—like the one we're participating in today—put investors on Wall Street on alert and fosters uncertainty.

That spells disaster for those start up companies out there that are thinking of bringing telecommunication services to Wyoming.

During this hearing I want to hear from all the witnesses on how these reciprocal compensation charges either hinder or help spur competition.

It is my position that if it hurts competition in any way or will end up costing Internet users more, I will have a hard time supporting the legislation before us today.

Again, Mr. Chairman, thank you for holding this hearing today. I look forward to hearing from the witnesses.

Mr. TAUZIN. Now that sets us up for our first panel, and it also is cause for me to remind you that your written statements are part of our record. So we would ask you in the 5 minutes allotted to each one of our witnesses to use the time to summarize the high points of your testimony for the committee.

Let me also define the schedule for the members and the witnesses. Ms. Smith has a 12:30 requirement, I think a presentation elsewhere in the Capitol. We are going to make time for you to leave and make that commitment, Joan. What we will do is, we will go through our panel and we will dismiss Ms. Smith so she can make her commitment; and ask you to return, if you can, after that commitment. We will continue our panel and our discussion, our dialog, with the panel.

We are told that there are votes scheduled about 1. So we will try to go until then and when we break for the votes, we will take an hour break to give everyone a chance to go to lunch and take care of business.

So we will proceed by first welcoming all the panel. I particularly want to welcome my friend from Louisiana, Jay Blossman, a member of our Public Service Commission and, I think, a rising star in Louisiana political history.

And welcome. We appreciate that you are here.

And also—my colleagues have also noted our friend, Mr. Tauke, who served this committee for many years and was an ally of mine in many deregulatory efforts.

Tom, welcome back.

We will start with our star witness from the FCC, Mr. Strickling, the Chief of the Common Carrier Bureau of the FCC; and I again remind you that we have a timer. We will set the timer and ask you to summarize within 5 minutes. Welcome, Mr. Strickling.

STATEMENTS OF LAWRENCE E. STRICKLING, CHIEF, COMMON CARRIER BUREAU, FEDERAL COMMUNICATIIONS COMMISSION; THOMAS J. TAUKE, EXECUTIVE VICE PRESIDENT, EXTERNAL AFFAIRS AND CORPORATION COMMUNICATIONS, BELL ATLANTIC; HON. JOAN SMITH, COMMISSIONER, OREGON PUBLIC UTILITY COMMISSION, AND CHAIR, NARUC TELECOMMUNICATIONS COMMITTEE; HON. JAY A. BLOSSMAN, JR., COMMISSIONER, LOUISIANA PUBLIC SERVICE COMMISSION; ERIC STRUMINGHER, MANAGING DIRECTOR, RESEARCH, PAINE WEBBER; AND CHAD KISSINGER, PRESIDENT, ON RAMP ACCESS INC.

Mr. STRICKLING. Good morning, Mr. Chairman, and members of the subcommittee. I want to thank you for the opportunity to testify here this morning on this issue of the regulatory treatment of dial-up telephone calls to the Internet.

My written statement provides a summary of the history of this issue in the enactment of the Telecommunications Act, so I won't repeat that discussion here except to respond to the questions you put to me in your opening statement.

You asked how, if the FCC could conclude that this traffic was interstate, we could then turn it over to the States to actually determine what compensation scheme should apply to it. And the answer is quite simple: At the same time that we made the declaration that the traffic was interstate, we needed then to undertake an additional rulemaking to set the Federal compensation scheme.

The Administrative Procedures Act requires that and we proceeded with that rulemaking at the time. But we were faced with the quite practical difficulty that this traffic existed today and there were contracts under which this traffic was being exchanged today, so what would the regime be for this interim period while the Commission could collect comments and determine what the Federal rule should be. It was in that context that the Commission said, well, let's preserve the status quo, let's allow these contracts and the State commissions, that had already been very actively engaged in this process, to continue to evaluate how to deal with this traffic until we could complete our rulemaking.

As you correctly observed, before we could conclude that rulemaking, the court of appeals intervened and said, well, wait a second, Commission, we want you to go back and take a second look at your jurisdictional determination.

That is back before us; it is an open proceeding. The Commission will be releasing a public notice in the next few days to seek additional comment and information from all the interested parties to that. And I do hope and expect that the Bureau will complete its work on this matter in time to meet the September 30 deadline that you and many other members of the committee have requested we do.

But it is important to understand that this Commission has never yet spoken to the question of what should be the compensation scheme, if any, that applies to this traffic, assuming it is interstate. Obviously, I am somewhat constrained in what I can say today, because this matter is in an open proceeding. But I do think it is certainly appropriate for the subcommittee to educate itself about the controversy today and evaluate whether legislation would be warranted. And in that spirit, while we again obviously can't provide a Commission recommendation on H.R. 4445 and whether it should be passed in its present form, I would like to offer some factual observations about the debate to assist members of the subcommittee as it evaluates the various positions of the stakeholders in this debate.

I'd like to offer five points for your consideration.

First, this issue of intercarrier compensation is much bigger than just the controversy over dial-up traffic to the Internet, and I would urge the subcommittee to take a look at all the various schemes that exist today for inter-carrier compensation before it decides to legislate on just this one piece of a much larger puzzle. We have separate compensation arrangements for pay phone providers, paging companies, long distance companies, competitive local exchange carriers. Depending on what label we apply to a transaction in one case, a carrier may receive compensation for delivering traffic to a second carrier, and in another, the same carrier performing the same function may be required to pay compensation to the carrier to which it delivers traffic. And this issue of the one way nature of Internet traffic again is not unique just to the Internet. There are other examples of particular services that are dealt with in various schemes, where again the traffic is one way. Chat lines would be an example. Indeed, cellular calls when they began, much of the traffic was almost all one-way, going there the wire line network—I am sorry—going from the wireless network to the wire line network. That has evolved over time.

But then last year we were in a situation where wire line companies received four times as many calls from cellular networks as traveled from the wire line network to the cellular network. Again, Mr. Tauke's companies and other local exchange carriers receive reciprocal compensation for that traffic even though it is weighted 4 to 1 in favor of the incumbent. Of course, it was in that context that the comments about the incumbents insisting on a constitutional right to compensation were made. Because at that time they saw that this traffic was going to be coming to them, and they wanted to make sure that they would be compensated for it.

In any event, given the different schemes that exist today, I would urge you to consider whether it makes sense to select just Internet traffic for legislative action.

Second, if there is to be compensation, we absolutely believe it should be cost based. One of the members referred to an economic windfall that may exist today for certain competitive carriers. But as Mr. Taylor of Focal observes in his written testimony, one of the reasons this compensation appears to be a problem is because at the time these agreements were negotiated 3 or 4 years ago, the incumbent carriers insisted on rates that were clearly well above cost. Rates in the range of a penny a minute, which were not unusual in these early agreements, are far higher than the actual cost of providing service.

We are very encouraged by the fact that as these contracts are expiring, the companies are negotiating between themselves far, far lower rates that are much closer to actual cost. We are now seeing rates negotiated as low as one- or two-tenths of a cent per minute. We also expect that further negotiations and arbitrations will lead to novel rate structures such as capacity charges, not based on per minute use or cap charges. We certainly encourage experimentation in that regard.

Third, any action that Congress takes should have as its goal to foster the continued development of local competition. Here I would observe that Mr. Tauke's argument that requiring the incumbents to pay competitive carriers that focus only on serving Internet service providers reduces their incentive to service other customers does make some sense as a theoretical matter, but we don't see that strategy being pursued in the marketplace by any significant number of competing carriers. On the contrary, companies such as Focal, headed by Mr. Taylor who will be testifying soon, seek to serve a wide range of customers in addition to the Internet service providers; and we have observed that, over time, the share of total revenue that companies such a Focal receive that are triggered to reciprocal compensation has dropped dramatically. I think last year, in the case of Focal, they have gone from 73 percent of their revenues being attributed to reciprocal compensation down to 35 percent in the past year. So we are seeing them expand just beyond serving Internet service providers to serving a much wider range of customers.

There are certainly examples, such as the North Carolina example that you mentioned, where a company was just terminating calls into a barn, of people who are out there, just scam artists. But we are finding that the State commissions, who we will hear from later, as well as State courts are well equipped to deal with these cases of fraud.

Commissions are refusing to certify competitors who seek only to serve one customer, you know, they are affiliated with Internet service providers. So we think that problem is being dealt with in the States.

Fourth, if Congress decides to legislate in this area, it should ensure that its action does not discourage the deployment of broadband advanced services. There is some suggestion in the written testimony that continuing the existing arrangements discourage investment in broadband technologies. I understand those arguments, but I think the subcommittee also needs to consider that the current scheme may also increase the incentives of the incumbent to invest in broadband technologies, because when they deploy the ADSL at that time, they are bringing back the Internet service provider to them as their customer, and as a result, their obligation to pay reciprocal compensation will be reduced.

Fifth and finally, I urge the subcommittee to take no action which might lead to the possibility that per minute charges to use the Internet might be imposed on consumers. In his prepared testimony, Mr. Tauke suggests that if H.R. 4445 is not passed, there will be a greater threat that end user charges will be imposed.

On the other hand, Mr. Taylor argues that passing H.R. 4445 will lead to significant increases in the prices consumers pay to access the Internet.

I cannot tell you today who is right in this and who is wrong. This is a factual issue we are pursuing in our proceeding. But I can say that Congress has made it very clear in other contexts that it does not want regulators imposing access charges on Internet service providers or otherwise taking action that might lead to consumers paying more to use the Internet.

That is very good advice. Chairman Kennard reminds us of this constantly, and I would urge the subcommittee to ensure that this goal is met in any legislation it pursues.

Those are my observations. I thank you for the opportunity to appear and I look forward to your questions.

[The prepared statement of Lawrence E. Strickling follows:]

PREPARED STATEMENT OF LAWRENCE E. STRICKLING, CHIEF, COMMON CARRIER BUREAU, FEDERAL COMMUNICATIONS COMMISSION

Good morning, Chairman Tauzin, and members of the Subcommittee, and thank you for the opportunity to appear before you today to testify regarding H.R. 4445, the "Reciprocal Compensation Adjustment Act of 2000." This legislation addresses the applicability of the reciprocal compensation provisions of the Telecommunications Act of 1996 (1996 Act) to dial-up Internet traffic, an issue that has occupied the attention of the state regulatory commissions and numerous courts as well as the Federal Communications Commission. The question of whether to require compensation for delivery of dial-up traffic to the Internet is a difficult and complex issue that admits of no easy solution from either a legal or policy perspective.

In order to put the current controversy in context, I first would like to trace the background of reciprocal compensation in the 1996 Act and how the statute and our rules implementing the law have been applied by state commissions and the courts. As part of the 1996 Act, Congress passed section 251(b)(5), which requires all local exchange carriers (LECs) "to establish reciprocal compensation arrangements for the transport and termination of telecommunications." Congress recognized that a carrier incurs costs when it delivers to one of its customers a local call that originates on the network of another carrier. Thus, the statute provides in section 252(d) that the reciprocal compensation arrangements must compensate carriers for the "additional costs of terminating such calls."

In August 1996, the FCC issued rules implementing section 251(b)(5). The FCC concluded that section 251(b)(5) applies only to "local" telecommunications traffic—traffic that originates and terminates within the same local calling area—and not to interstate traffic. We reasoned that Congress intended reciprocal compensation to address the situation in which two carriers collaborate to complete a local call, a scenario that would occur with increasing frequency as competition developed in the local exchange market as a result of the 1996 Act. Access charges, not reciprocal compensation, would continue to apply when three carriers—typically the originating LEC, a long distance carrier, and a terminating LEC—collaborated to complete a long distance call. In the access charge regime, the caller pays the long distance carrier, which in turn must pay both LECs for originating and terminating access service. Neither our reciprocal compensation rules nor our access charge rules directly addressed the situation where two local carriers collaborate to deliver dial-up traffic to the Internet.

In the course of arbitrating and interpreting local interconnection agreements under sections 251 and 252, state commissions were presented with claims from competitive local carriers (CLECs) that they should receive reciprocal compensation, as defined in section 251(b)(5), for dial-up Internet traffic that they transported from incumbent carriers to Internet service providers (ISPs) served by the competitive carriers. ISPs provide their customers the ability to access the Internet. An ISP subscriber typically will dial a seven-digit number to reach an ISP server in the same local calling area, and the ISP then provides routing and transmission services to enable its subscribers to access Internet content and services throughout the United States and the world.

The competitive carriers have generally contended that traffic bound for ISPs is local telecommunications traffic that terminates at the local ISP server and is thus subject to reciprocal compensation under section 251. Incumbent LECs have asserted that this traffic is interstate traffic and, therefore, beyond the scope of section 251(b)(5). The incumbent carriers have pointed out that the FCC has characterized enhanced service providers (ESPs), a category that includes ISPs, as users of interstate access services and that the FCC explicitly exempts ESPs from the payment of certain interstate access charges. They have argued that our adoption of this "ESP exemption" reflects our understanding that ESPs use interstate access services; otherwise, no exemption from access charges would be necessary.

More than two dozen state commissions concluded that the interconnection agreements that incumbent LECs had entered into with CLECs required the payment of reciprocal compensation for ISP-bound traffic. Many of these states accepted the "two call" argument advanced by the CLECs and concluded that the "telecommunications" in question terminated at the ISP's local server. This "local" call, for which reciprocal compensation was due, was then followed by a second "call" initiated by the ISP server to access the Internet.

In February 1999, in response to requests from both incumbent and competitive LECs, the FCC issued a decision clarifying that ISP-bound calls are not local calls and therefore are not subject to reciprocal compensation under our rules implementing section 251(b)(5). In that decision, we noted that the FCC traditionally has determined the jurisdictional nature of communications by the end points of the communication—where a call starts and where it ends—and has rejected attempts to divide communications at intermediate points of switching or exchanges between carriers. Using this "end-to-end" analysis, we concluded that ISP-bound telecommunications traffic does not terminate at the ISP's local server but continues to its ultimate destination, an Internet website that is often located in another state or even in another country. We found, therefore, that ISP-traffic is jurisdictionally mixed, largely interstate, and thus, not subject to our rules on reciprocal compensation for local traffic. We explained that this result is consistent with the statutory definition of "information service," which makes clear that these services, including Internet access services, are provided "via telecommunications," thus rebutting the argument that the telecommunications traffic terminates at the ISP server. It also accords with the ESP exemption and the FCC's historic characterization of ISPs as users of interstate access services. We stressed that the decision in no way altered the ESP exemption. To the contrary, the FCC acted in this instance for the purpose of ensuring that the Internet continues to flourish under our "hands off" regulatory approach.

However, having determined that dial-up Internet traffic was interstate in nature, the FCC emphasized that the jurisdictional finding did not answer the question whether compensation should be paid. The FCC acknowledged that there was no federal rule of compensation and no federal mechanism by which carriers should compensate one another for delivering this traffic. In the absence of a federal rule, we initiated a rulemaking to determine whether to establish a federal intercarrier compensation mechanism for ISP-bound traffic.

In the interim, we stated that parties were bound by their interconnection agreements as interpreted and enforced by state commissions. Accordingly, state commissions have continued to address this issue. Many states have required local exchange carriers to pay reciprocal compensation for these calls, and none of these decisions has been overturned in court. A few commissions have concluded, however, that no compensation is required. Other states have developed innovative compensation schemes that take into account the extent of traffic imbalance. The Massachusetts Department of Telecommunications and Energy, for example, adopted on an interim basis a proposal by the incumbent carrier, Bell Atlantic, that it would not pay reciprocal compensation for traffic that exceeds a 2:1 ratio in favor of the CLEC, unless the CLEC demonstrates that the imbalance is not associated with ISP-bound traffic. The New York Public Service Commission took a similar approach, holding that Bell Atlantic could pay a lower rate to a CLEC for all terminating traffic that exceeds originating traffic by a 3:1 ratio, unless the CLEC could rebut the presumption that the traffic imbalance results in lower costs. Other commissions have imposed a "bill and keep" regime for ISP-bound traffic, which requires each carrier to recover the costs of carrying that traffic from its own end users.

Most significant, perhaps, are the agreements that parties have reached through private negotiation. Many incumbent local exchange carriers insisted on reciprocal compensation rates as high as $.01 per minute in agreements they entered into with competitive entrants in 1996, based on the apparent expectation that they would be the net beneficiaries of these payments. These agreements are expiring, however, and some of these same carriers are now negotiating dramatically lower reciprocal compensation rates for all traffic, including ISP-bound traffic—as low as $.00175 per minute. Consumers will be better off and local competition will be fostered as parties continue to negotiate rates that more accurately reflect the actual costs of transport and termination.

Before we could complete the rulemaking, on March 24, the Court of Appeals for the D.C. Circuit vacated our decision on the regulatory treatment of dial-up Internet traffic and remanded the matter to the FCC. The Court agreed that the FCC may examine the end points of a call—whether it originates in one state and terminates in another—in order to determine the jurisdictional nature of the communication. The Court felt, however, that we had not adequately explained how that jurisdictional analysis is relevant to determining whether ISP-bound traffic is subject to the reciprocal compensation obligations of section 251(b)(5). The Court also struggled to understand whether our conclusion that ISPs use interstate "access service," which is not defined in the Act, is consistent with the statutory definitions of "telephone exchange service" and "exchange access service," neither of which explicitly encompasses Internet access service.

In response to the Court's remand, the Common Carrier Bureau has recommended to the Commission that it issue a notice inviting parties to comment on the court's decision. The notice will also request parties to provide information about any new intercarrier compensation arrangements that they may have entered into, either as a result of private negotiation or at the direction of a state commission. Once these comments are received, we will reexamine our conclusions regarding the jurisdictional nature of ISP-bound traffic and the scope of the reciprocal compensation provisions of section 251(b)(5). While it would be premature now to suggest how the Commission might rule on this matter, we previously have identified broad policy principles to guide our analysis. The mandate of the 1996 Act that we "preserve the vibrant and competitive free market that presently exists for the Internet and other interactive computer services' underscores the strong federal interest in ensuring that regulation does nothing to impede the growth of the Internet. It is also incumbent upon us to realize Congress' goal of promoting competitive entry into markets for *all* telecommunications services, including local telephone and Internet access services, in a manner that yields tangible benefits to consumers of those services.

Thank you again for the opportunity to testify. I look forward to working with the Subcommittee as it addresses this important issue.

Mr. TAUZIN. Thank you very much Mr. Strickling.

And now we welcome again our former colleague, the Honorable Tom Tauke, Executive Vice President, External Affairs and Corporate Communications of Bell Atlantic.

Mr. Tauke.

STATEMENT OF THOMAS J. TAUKE

Mr. TAUKE. Thank you, Mr. Chairman and distinguished members. It is good to be here. I had a nice statement about explaining the issue, but all of you have done that so well that I will take a little different tack and focus on the question that Congressman Shimkus asked, what does this mean for consumers?

I think that for consumers it is essentially—there are essentially two questions: How can you best prevent the charges for Internet usage, the permanent charges for Internet use; and how can you get real competition for residential consumers in the local exchange marketplace? I brought a couple of charts with me that focus on these two issues.

First, this committee has had a lot of interest in trying to prevent Internet—permitted Internet charges. And the first chart, at the top, deals with the old problem that we have been resolving for years. And that is the prevention of the application of traditional access charges, long distance access charges to Internet traffic.

If we had permitted access charges to apply to Internet traffic, and assuming that you had a penny a minute for Internet access charges and assuming that a typical Internet customer is online 2 hours a day, then you would have a situation where you would have $36 flowing from a CLEC, or company B in this case, to an incumbent company like Bell Atlantic, $36 a month that would be the result of the payment of interstate access charges for that Internet traffic to the incumbent local exchange carrier.

Now the bottom line is that the FCC long ago recognized that was a problem, said, no, even though these are interstate calls, we don't want to have interstate access charges. So they said, no access charges. This became known as the ESP exemption. This committee and the House of Representatives several weeks ago passed the Upton bill which confirmed in statute, or is attempting to confirm in statute, that indeed there will be no application of interstate access charges to this Internet traffic which has been declared interstate. So that is the old problem.

Now, there is the current problem which is the reciprocal compensation problem. That problem has a different application in this case of reciprocal compensation for local traffic trying to apply that scheme to Internet traffic.

Now, just understand reciprocal compensation was applied to local voice traffic. That is what it was structured to do. This traffic has been declared interstate by the FCC. But as the FCC representative, Mr. Strickling, has indicated, they haven't set a compensation scheme yet. So while we are waiting around for this—and the wait has been a long time—the reciprocal compensation scheme is being applied, even though it was never intended for this kind of traffic.

If somebody is online 2 hours a day, and if the CLEC gets in front of the ISP and says this is incoming traffic, what happens is you have $18 a month flowing from Bell Atlantic to a CLEC. Now, I think it is fair to say that this is a lot of money when you are collecting $15 per customer on average for the second line. You collect $15, you pay out $18. For Bell Atlantic, this has amounted to, the first 3 months of this year, over $60 million a month. It is doubling every year.

We can hide this in the wash for awhile, and the local exchange companies across the country have been doing that for the last couple of years; but it is getting to the point that it is too big to hide any longer and something has to give.

So what gives? Well, I think we are seeing that with Roseville telephone in California. One of the small telephone companies in California, Roseville just filed with the California commission and said, the way this is going, we have to implement a charge on Internet usage by our telephone customers because we can't keep shelling out this money with nothing coming in; something has to give. We are proposing a permanent Internet usage charge.

For all of the companies who are on the paying end, they have got to recover it someplace; it is a real cost for the companies that are paying. And one alternative is to have an Internet charge; another alternative is to dump it on other customers, which doesn't seem fair.

I think it is important to note that there is a big question about what the real costs are for company B that is receiving the $18. And if I read my testimony and the testimony from the gentleman from Focal, you get different answers, but the bottom line is, we can have discussion of this.

There is no evidence that the cost is anything related to the $18 a month. H.R. 4445 tries to say, no payment either way under either of these schemes. But it does not—and I emphasize this—it does not prevent the FCC from establishing a different kind of compensation system for Internet-bound traffic.

The incumbent local exchange industry has been over and over again saying, let people recover their costs by some mechanism;

and we continue to adhere to that view. But reciprocal compensation doesn't permit that.

And the second thing that I was going to talk about, but I know I have run out of time, is why this hinders local competition. The bottom line is, if you look at that other chart, if a CLEC today is serving an ISP, they have the ability while serving that ISP to be able to make about—I can't see the number there, but I think it is about $18 a month in reciprocal compensation with essentially no cost.

If they go off and serve, however, the residential customer and take that line, let's say from a Bell Atlantic, and serve that customer themselves, they lose $16 a month. It is not hard for them to figure out what business plan they ought to pursue.

And so, yes, Mr. Strickling says Focal is serving other customers, but look at their annual report. They aren't interested in serving residential customers and they aren't going to be interested in getting that second line from this residential customer because it is a loser for them under the current compensation scheme.

Mr. Chairman, thank you very much.

[The prepared statement of Thomas J. Tauke follows:]

PREPARED STATEMENT OF THOMAS J. TAUKE, EXECUTIVE VICE PRESIDENT, EXTERNAL AFFAIRS & CORPORATE COMMUNICATIONS, BELL ATLANTIC

Mr. Chairman, thank you for this opportunity to testify before the Committee. I am Tom Tauke, Executive Vice President of External Affairs & Corporate Communications for Bell Atlantic. I am also Chairman of the United States Telecom Association, and I appear on behalf of that Association. I am before you today to urge you to correct an unintended consequence of the Telecommunications Act of 1996, an unintended consequence that actually *reduces* companies' incentives to compete in the local exchange business. If not corrected, this unintended consequence also could result in per minute charges being imposed on Internet use, a result that, I know, no Member of this Committee desires.

The problem that H.R. 4445 seeks to fix is a problem with the way the Telecommunications Act has been warped to undermine the purposes of that Act. As the Massachusetts commission wrote:

> "The unqualified payment of reciprocal compensation for ISP-bound traffic . . . does not promote real competition in telecommunications. Rather, it enriches competitive local exchange carriers, Internet service providers, and Internet users at the expense of telephone customers or shareholders. This is done under the guise of what purports to be competition, but is really just an unintended arbitrage opportunity derived from regulations that were designed to promote real competition." [1]

And the Colorado commission agreed:

> "[W]e find that reciprocal compensation would introduce a series of unwanted distortions into the market. These include: (1) cross-subsidization of CLECs, ISPs, and Internet users by the ILEC's customers who do not use the Internet; (2) excessive use of the Internet; (3) excessive entry into the market by CLECs specializing in ISP traffic mainly for the purpose of receiving compensation from the ILECs; and (4) disincentives for CLECs to offer either residential service or advanced services themselves." [2]

Congress needs to act to prevent this situation from continuing.

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[1] *Complaint of MCI WorldCom, Inc. against New England Telephone and Telegraph Company d/b/a Bell Atlantic-Massachusetts for breach of interconnection terms entered into under Sections 251 and 252 of the Telecommunications Act of 1996,* D.T.E. 97-116-C at 25-26.

[2] *Petition of Sprint Communications Company, L.P. for Arbitration Pursuant to U.S. Code* § 252(b) of the Telecommunications Act of 1996 To Establish an Interconnection Agreement with U S West Communications, Inc., DOCKET NO. 00B-011T, Initial Commission Decision at 22 (May 3, 2000).

"RECIPROCAL COMPENSATION"

The subject of this hearing, and of H.R. 4445, is one provision of that Act that has not worked out exactly as Congress intended and, in fact, has had a perverse effect on competitive incentives—an effect that none of us could have foreseen in 1994 and 1995 during the debates that led to the passage of the Act.

Section 251(b)(5) establishes a mechanism for local telephone companies to compensate each other for handling local calls, a system referred to as "reciprocal compensation." Under this system, one telephone company pays another telephone company for each local call the second company completes to one of its customers. For example, if Company A is your local telephone company and you make a local call to a friend who uses Company B, another telephone company, Company A pays Company B for completing your call. When your friend calls you, Company B pays Company A for completing the call. This compensation system is truly "reciprocal," and the payments flow in both directions. This system makes sense and has worked well for local calling.

. . . ENTER THE INTERNET

But calls to the Internet are anything but "local." Your call to the Internet does not stay in your local area, but goes across the country or around the world. The FCC has recognized this fact and has declared calls to the Internet to be interstate and interexchange, but not local.

However, some companies have figured out ways to make money—in some instances quite a lot of money—by applying the Act's system for compensating carriers for handling local calls to calls to the Internet. And with the explosive growth of calls to the Internet, in short time since the '96 Act was passed, this has resulted in payments of billions of dollars for calls that were never intended to be part of this compensation system.

This is how it works: Consumers get access to the Internet through Internet Service Providers (ISPs). If your local telephone company—Company A—connects directly to your ISP, there is no compensation payment. However, if Company B signs up your ISP, then Company B can demand that Company A pay local service compensation for Internet-bound calls. Of course, the Internet is not going to call you back, and there is no reciprocity in calls, and no balance in payments.

In fact, the application of reciprocal compensation to Internet-bound traffic has spawned a generation of "telephone companies" that have few or no facilities at all. Many times Company B is just a shell that provides little or no service. Thus, Company B can set up its arrangements so that it has no facilities of its own and simply gets Company A to deliver the calls directly to the ISP. Company A still has to pay Company B, even though Company A provides the entire service and Company B does nothing at all—other than cash the compensation checks.

This has been a major problem for local telephone companies. The latest estimates are that compensation payments for Internet-bound calls will exceed two billion dollars this year. And if history is any guide, they will double next year. Some state commissions have taken steps to stop these abuses. However, this is a federal issue, under federal law, and should be dealt with on a consistent national basis on the federal level.

THE UNINTENDED CONSEQUENCES

H.R. 4445 will confirm that calls to the Internet are interstate, not local, and therefore, that the compensation system for local calls does not apply to them. If Congress does not make this simple clarification it will allow the existing skewed, uneconomic system to continue. It will also unjustly reward carriers that are essentially doing nothing to enhance the competitive marketplace.

More important, it's bad for competition, the very competition that Congress enacted the '96 Act to encourage. It's hard work going out into the marketplace to compete for the business of hundreds or thousands of individual telephone customers. It's relatively easy to try to sell to one or two ISPs—especially when you can offer them exceptionally low priced service based on the compensation payments you will receive. As a result, many competing telephone companies have decided it is better to serve a few ISPs and reap these windfall profits than to invest and to compete to serve consumers.

And that's not the worst part—actually serving residential customers would reduce their revenues. Because it is available only when a customer's line is served by another carrier, Internet reciprocal compensation actually pays carriers *not* to invest in their own competing facilities and *not* to provide their own competing service to residence or small business customers. As a Wall Street analyst observed, "it turns customers from an asset to a liability." As both the Massachusetts and Colorado public utility commissions found, the economics of applying reciprocal compensation to Internet-bound calls are simply too attractive to make entering the competitive fray worth the candle.

Let me give an example. Assume Company A has a residential customer that uses her second line for two hours each day to reach her ISP, which uses Company B. Reciprocal compensation rates range up to 1.2 cents per minute. So at a moderate rate of ½ cent per minute, Company A pays Company B $18 per month for this customer's Internet use.

Two-hours-per-day is just moderate Internet use—many consumers routinely spend more time on line, doing e-mail, surfing the Web and "chatting" with friends. And compensation on Internet-bound calls gives carriers an incentive to artificially increase this amount. In fact, at least one provider has indicated that its customers may be logged on full time. At ½ cent per minute, Company A's liability would be $216 per month.

Whether the compensation is $18, $216 or somewhere in between, it is more than the $15 basic typical monthly charge for this line (a rate that does not cover the real costs of providing the service). And because this is a second line, the customer will not be using it to make long distance calls and will not be buying value-added features for it. Providing this service is clearly a losing proposition for Company A.

But these numbers also show why Company B will never try to sign up this residential customer. If the customer moves to Company B, Company B will gain the $15 monthly service fee from the customer, but it will lose the $18 it gets in compensation and will incur at least $13 in real costs to serve the customer—an overall loss of $16. To make matters worse for Company B, if the customer then changes ISPs (or the ISP switches to Company C), Company B actually has to pay out $18 in compensation to Company C, making Company B $34 per month worse off for signing up the residential customer.

This situation also has unhealthy consequences for the deployment of advanced services. It drains millions and millions of dollars from the local telephone industry that would otherwise be invested in local networks to provide new and better services. In addition, Internet-bound calls could be handled more efficiently by moving them off the circuit-switched network, and onto more efficient packet-switched technologies. However, there is no incentive to deploy these technologies if they won't be used. But as long as ISPs (or their carrier affiliates) can get paid reciprocal compensation if they stay on the circuit-switched network, they have little incentive to move to new packet-switched technologies, no matter how reasonably priced. And as long as no one is willing to use these new technologies, there is little incentive for originating carriers to deploy them in the first place.

What will happen if Congress doesn't fix this problem? Local telephone companies are faced with multi-billion dollar annual outflows of cash. They have two ways to respond. The most logical is to pass on their compensation costs to the customers that cause them—those who use the Internet. If Company A pays ½ cent per minute because a consumer calls the Internet, then Company A would bill that ½-cent-per-minute to the consumer. The other alternative would be for Company A to recover these costs from all its local customers, which would result in consumers who do not use the Internet subsidizing those who do.

The reciprocal compensation provisions of the '96 Act do not apply to calls to the Internet, and Congress should put any arguments to the contrary permanently to rest by passing H.R. 4445.

Mr. TAUZIN. Thank you very much, Mr. Tauke.

I now will welcome the Honorable Joan Smith, Commissioner the Oregon Public Utility Commission, who chairs the NARUC Telecommunications Committee in Salem, Oregon.

Joan Smith.

STATEMENT OF HON. JOAN SMITH

Ms. SMITH. Thank you, Mr. Chairman. For the record, my name is Joan Smith from Oregon. I would like to thank you and the members of the subcommittee for offering me this opportunity to discuss the State's views of H.R. 4445, the Reciprocal Compensation Act of 2000.

As Chairman of the National Association of Regulatory Utility Committees on Telecommunications and a member of the Oregon

Commission, I am deeply concerned about the negative impacts that H.R. 4445 could have on consumers, the competitive marketplace and on the carefully crafted structure of the 1996 act. And I too had some and—there they are, posters which are not quite as elegant as some of the rest of the posters have been, but just to dwell on them for a moment—and I must say to you, in this day and age, regulators, I am afraid, are considered agents of the devil—but I want you to know that my duties are purely ceremonial.

When we started in to look at reciprocal compensation, who would have expected, as many of you pointed out, that the traffic would be anything but balanced? And those little cars and trucks just show that that is what we thought would happen. And bill and keep was certainly a choice. But if we go to the next poster, lo and behold, traffic to the Internet, as many of you have pointed out, had longer holding times and, therefore, under the old scheme, more minutes and, therefore, more money. And that is the dilemma that we face today through this bill.

I would just like to remind you that in the act of 1996 there is no preset regime for how reciprocal compensation works. There is no instruction, you will do this and you will do that. It has basically been worked out over time. So when we use reciprocal compensation, unfortunately the semantics are such that it is bad. It is unfair.

But, again, I would like to remind the committee that it is a two-party arrangement, by and large, and that it can be worked out, that it is renegotiable and that this is a contract. And most of the States do not dictate what kind of scheme there should be. We leave it to the two business entities to figure out what is best for them. But as you have pointed out, of course, there is this imbalance and an imbalance of payments.

So what is the key issue for the States? We worry that H.R. 4445 singles out a certain type of traffic, that it is technology specific. What happens when the next imbalance occurs? Will there be another bill? We strive to make sure that our regulations are technology-neutral. The key here, of course, as all of you have noted, is that there is no payment in the bill for this service; and no payment, it seems to us, may not be fair and even invite litigation.

Where do those costs go? Even though we partially deregulate the environment, it is still a zero sum game. Some think that the cost will go to Internet users, as Mr. Tauke pointed out. Some think that it will fall back on all the customers to support advance services. We really can't know at this point, but both dangers exist.

The reciprocal compensation issue, in our minds, is best addressed through the existing statutory regulatory framework of the act. Under this act, as I pointed out, the incumbent and competitive carriers are required to negotiate and the States are required to arbitrate disagreements. And we think we have done a pretty good job, by and large; 38 States have ruled on the issue—33, that dialing is a local issue and intrastate issue, and the fifth, seventh and ninth circuits have agreed.

We, of course, are waiting on the FCC as well. And obviously that is ultimately a public policy call, your call, on whose jurisdiction is which.

So, summing up, I would like to say that basically we are worried whenever a service is provided by one carrier to another carrier. There is no compensation. What happens? And I have a few solutions.

One, as other people have noted, when there is arbitrage going on, why not make that illegal? It is not too hard to seek that out and figure it out. Why not use solutions like the New York Public Service Commission's solution and reciprocal compensation that checks out whether carriers are truly carriers and carry lots of kinds of traffic, not just Internet, and put aside money for infrastructure improvement and investment. Why not consider the fact that paying for minutes per use is really pretty old fashioned? I think we need to look at other ways to pay for traffic, for example, a flat rate.

And third, I would suggest that Congress look at the States as near the traffic, near the customers, near the parties and ask us to continue, as the act suggests, sorting out the issues around compensation and so much that is a part of the act.

If Congress and if the FCC declare that this is an interstate transaction, then we would insist, ask, beg, plead, kneel——

Mr. TAUZIN. Never.

Ms. SMITH. [continuing] that the costs associated with that decision go with the jurisdiction. And we are talking billions here.

And I thank you again, Mr. Chairman.

[The prepared statement of Hon. Joan Smith follows:]

PREPARED STATEMENT OF JOAN SMITH, COMMISSIONER, OREGON PUBLIC UTILITIES COMMISSION

Thank you, Mr. Chairman and Members of the Subcommittee, for offering me this opportunity to discuss the states' view of H.R. 4445, The Reciprocal Compensation Act of 2000. As Chairman of the National Association of Regulatory Utility Commissioners (NARUC) Committee on Telecommunications, I am deeply concerned about the negative impacts that H.R. 4445 could have on consumers and the competitive marketplace.

The 1996 Telecommunications Act was about encouraging the development of a competitive marketplace for local telephone services. The Act was also about encouraging the deployment of advanced telecommunications services, which are often called broadband services. Our hope was that consumers would benefit from lower prices and have a broader array of telecommunications services and technologies to choose from.

So far, Congress has wisely held itself back from tinkering with the carefully crafted system it created in the Act. If H.R. 4445 becomes law, the balance of that system will be upset and the progress that is being made will be seriously undermined. This bill will also invite costly and unnecessary litigation both on the state and federal level.

Before there was competition in the local exchange market, a single provider served all telephone customers. That sole provider both originated and terminated telephone calls on behalf of its customers whenever those customers made a local call. The revenues collected from customers by that single company covered both the origination and termination costs of its customers' local calls. I fear that there is a lot of misinformation and confusion about this matter and I would be happy to explain this issue to any of you in more detail if necessary.

Now, the customers at the two ends of a local telephone call might be served by two different telecommunications carriers. One originates the call, and one terminates the call. Both carriers take part in carrying this "traffic". Both carriers should be paid for the services they provide to customers. The Act's reciprocal compensation provisions were designed to ensure that, when more than one company handles a local telephone call, both of those companies will be paid for their services.

In many cases, a local exchange carrier can assume that their customers will call the customers of another local exchange carrier serving the same local area about the same number of times that the customers of the other carrier will call their own customers. Traffic is balanced, and a "bill and keep" method of payment can be employed, or a reciprocal compensation agreement may be reached.

In the case where a local exchange customer is an Internet Service Provider (ISP), local calls will be made to the ISP, but the ISP will not be making local calls from its dial-up numbers. H.R. 4445 would eliminate the requirement that the ISP's local exchange carrier be paid for transporting and terminating calls to its customer ISP, but it does not eliminate the requirement that the ISP's local exchange carrier must provide that service. In other words, it changes the Act so that a business is required to provide a service for free to its competitors.

Without revenues to offset the costs of providing telecommunications service, a company terminating calls (often a competitive local exchange carrier rather than an incumbent Bell company) would have to increase prices to offset the loss in reciprocal compensation revenues. This may choke the flow of investment in broadband services and new technologies. The increase in rates would make the company less competitive, and it would, in turn, raise the ISP's costs, which, in turn, would raise the cost to consumers who access the Internet. Congress should not create a special exemption for the Bell companies who are seeking a legislative fix to system they fought hard to have in 1996.

The reciprocal compensation issue is best addressed through the existing statutory and regulatory framework in the Act. Under the Act, incumbent and competitive carriers are required to negotiate reciprocal compensation payments. If these negotiations break down, state commissions are given the responsibility to arbitrate any disputes. Thirty-eight state commissions have ruled on the issue, 33 of which have found that dialing a local number to reach an ISP should be treated like any other local call to a business customer.

We must not forget that just after the Act passed, Bell companies successfully argued before state commissions that reciprocal compensation was the payment of choice. H.R. 4445 alters the payment process to significantly favor the Bell companies at the expense of new entrants. H.R. 4445 also assumes that the decisions made by state commissions are irrelevant and that the federal government knows best.

If Congress continues to adhere to the goals of the 1996 Act, consumers will continue to see lower prices and more choice in services. H.R. 4445 runs directly counter to these goals. I urge you to reaffirm your support for the 1996 Act which your state colleagues have worked so hard to implement and not move forward with H.R. 4445.

Mr. TAUZIN. Thank you, Ms. Smith.

And now we are pleased to welcome a fellow Louisianan, Jay Blossman, Jr., one of our Louisiana Public Service Commissioners from Mandeville, Louisiana.

Mr. Blossman.

STATEMENT OF HON. JAY A. BLOSSMAN, JR.

Mr. BLOSSMAN. Thank you, Mr. Chairman.

Good afternoon, and as the chairman said, I have been asked to give a State public service commissioner's perspective on the issue of payment of recall compensation for transport and delivery of Internet traffic to Internet service providers.

The Louisiana Public Service Commission examined this issue in depth in a case brought before it in early 1999, in which a CLEC has sought payment of reciprocal compensation for local traffic in its interconnection agreement. A majority of the Commission concluded in that case that reciprocal compensation was not owed for this traffic for basically three reasons:

First, the FCC has made it clear that reciprocal compensation under the Telecom Act of 1996 is owed for local traffic only. The FCC has traditionally classified Internet traffic as, jurisdictionally, interstate switched access traffic. The FCC has traditionally regulated this Internet traffic. We State commissions certainly have not.

The FCC is the agency that created the exemption for policy reasons that ISPs historically have enjoyed from the requirement that switched access charges be paid on switched access traffic. Obviously, there would have been no need to create this exemption in the first place if this traffic were in fact local traffic.

Second, the evidence of the actual intent in the record and the language of the contract itself supported the conclusion that the parties did not intend to pay reciprocal compensation for this traffic.

Third, the evidence in the records showed that an award of reciprocal compensation in this case would have resulted in an unwarranted and irrational windfall to the plaintiff. In my view, awarding this kind of free money to competitors is not what the 1996 act contemplated. If reciprocal compensation is paid for Internet-bound traffic, I would have to provide a mechanism for the incumbent LECs, who are originating most of this traffic, to recover that cost. When that happens, I may be forced to consider higher rates for consumers, and this is something I don't want to see.

In its own pending rulemaking proceeding on this issue the FCC has said that in the interim, and until it issues a binding ruling, the State commissions are free to adopt or not to adopts a compensation scheme for this traffic.

The Louisiana Public Service Commission has opened a generic docket to consider what compensation mechamisms other than reciprocal compensation may be appropriate, pending the FCC's ruling. I am open to a fair cost recovery scheme for all concerned.

In summary, I want to close by stating that I am anxious for the FCC to expeditiously resolve its pending rulemaking on this issue, and it is my belief that many State commissioners are also waiting for the FCC to act. Rather than give this issue renewed attention, it is my personal opinion that the industry and State commissioners alike would like—would all be best served by the FCC's rapid resolution of its rulemaking proceeding. The litigation spawned by this one issue has gone on long enough and has taxed the resources of everyone concerned.

Again, I want to thank you for being here today, and I will answer any questions you have, Mr. Chairman.

[The prepared statement of Jay A. Blossman, Jr. follows:]

PREPARED STATEMENT OF JAY BLOSSMAN, COMMISSIONER, LOUISIANA PUBLIC SERVICE COMMISSION

Good morning/afternoon. I have been asked to give a state public service commissioner's perspective on the issue of payment of reciprocal compensation for transport and delivery of internet traffic to Internet Service Providers.

The Louisiana Public Service Commission examined this issue in depth in a complaint case brought before it in early 1999 in which a competitive local exchange carrier sought payment of the reciprocal compensation rate for local traffic in its interconnection agreement—$.09 per minute—for the transport and delivery of internet traffic to its ISP customers. A majority of the commission concluded in that case that reciprocal compensation was not owed for this traffic for basically three reasons:

First, and as a matter of law, the FCC has made it clear that reciprocal compensation under the Telecommunications Act of 1996 is owed for local traffic only. It is not owed for the transport and termination of interstate traffic. I am convinced as a matter of law that internet traffic is not local traffic. The FCC has traditionally classified internet traffic as jurisdictionally interstate switched access traffic. The FCC has traditionally regulated this internet traffic (we state commissions certainly have not). The FCC is the agency that created the exemption, for policy reasons, that ISPs historically have enjoyed from the requirement that switched access charges be paid on switched access traffic. Obviously, there would have been no need to create this exemption in the first place if this traffic were in fact local traffic.

Second, in my view, the evidence of actual intent in the record and the language of the contract itself supported the conclusion that the parties did not intend to pay reciprocal compensation for this traffic. For example, the contract clearly limited the parties' obligation to pay reciprocal compensation to what was required by law, nothing more and nothing less. That certainly made sense to me. And as I've already stated, the law is clear that reciprocal compensation is owed for local traffic only, not interstate traffic. Moreover, the contract contained an express exemption for payment of reciprocal compensation on switched access traffic.

Third, the evidence in the record showed that an award of reciprocal compensation in this case would have resulted in an unwarranted and irrational windfall to the plaintiff. Indeed, the evidence showed that the reciprocal compensation sought by the plaintiff exceeded by over 300% the total revenues received by the plaintiff for providing local service to its 10 ISP customers. In my view, awarding this kind of "free money" to competitors is not what the 1996 Act contemplated. It would create perverse economic incentives that would seriously inhibit the rapid development of competition in the residential marketplace. In addition, from my perspective as a state public service commissioner, if reciprocal compensation is paid on internet bound traffic, I would have to provide a mechanism for the incumbent LECs who are originating most of this traffic to recover that cost. When that happens, I may be forced to consider higher rates for my constituents, the ratepayers of Louisiana, and that is something I don't want to see.

I am aware that some carries have argued strenuously that they are entitled to recoup their costs of transporting and terminating this traffic. (I note for this record that the plaintiff in the case before the LPSC chose not to offer any evidence of any actual costs incurred). Nothing the LPSC has done to date has foreclosed that possibility. Nor is it my understanding that HR 4445 is intended to foreclose this possibility; rather it provides only that reciprocal compensation under the 1996 shall not be paid for this traffic. I agree for the reasons I have stated that reciprocal compensation under the 1996 Act is not appropriate because this traffic is not local.

In its own pending rulemaking proceeding on this issue, the FCC itself has commented that efficient rates for inter-carrier compensation for ISP-bound traffic are not likely to be based entirely on minute-of-use pricing structures; and that, in particular, pure minute-of-use pricing structures are not likely to reflect accurately how costs are incurred for delivering ISP-bound traffic. Further, the FCC has said that, in the interim, and until it issues a binding ruling, the state commissions are free "to adopt (or not adopt) a compensation scheme for this traffic."

In fact, the LPSC has opened a generic docket to consider what compensation mechanism other than reciprocal compensation may be appropriate pending the FCC's ruling. I note that I have heard arguments, not only that CLECs are not recovering adequate compensation for delivering this traffic to their ISP customers, but also from ILECs that they are not adequately compensated for originating this traffic from their local exchange customers. I would look forward to seeing in our generic docket evidence of the actual costs incurred in originating and sending this traffic to ISP customers, and whether or not those costs are being covered today, for example, whether ILECs are compensated for originating this traffic through the basic local exchange rates paid by their customers, and whether CLECs are compensated for delivering this traffic by the ISDN or other line rates paid by their ISP customers. If costs are not being recovered, I am open to a fair cost recovery scheme for all concerned. I fully support the fair recovery of actually incurred costs. What I cannot support is a system that will result in over-recovery of costs and the subsidization of one competitor by another or one competitor by another competitor's end user customers. And that is what I believe will happen if reciprocal compensation for ISP bound traffic is required.

In summary, I want to close by stating that I am anxious for the FCC to expeditiously resolve its pending rulemaking on this issue, and it is my belief that many state commissions are also waiting for the FCC to act, rather than give this issue renewed attention. It is my personal opinion that the industry and state commissions alike would all be best served by the FCC's rapid resolution of its rule-making proceeding. The litigation spawned by this one issue has gone on long enough and has taxed the resources of everyone concerned.

Thanks for the opportunity to be here today.

Mr. TAUZIN. Thank you, Mr. Blossman.

Ms. Smith, if at any time you need to move over to your other function, you are more than welcome to do that. As we invited the Commission and the ILECs and CLECs and since we also asked for some advice from those who determine, in effect, how these markets work and how these companies are valued; and so we brought someone from PaineWebber, Mr. Eric Strumingher, Managing Director, Research, from PaineWebber in New York.

We welcome you Mr. Strumingher.

STATEMENT OF ERIC STRUMINGHER

Mr. STRUMINGHER. Thanks for having me Mr. Chairman, members of the committee. I am a security analyst, as the chairman said. I hope that I can give you a view about how the issues that you are examining today are going to affect the financial markets.

I am not here representing any particular group, and I hope that I don't harbor any strong biases one way or another. As evidence of that, I have buy recommendations to my investment clients for companies that benefit from the current scheme of reciprocal compensation and also those who are taking a hit. So I really hope that that can substantiate my claim that I am not biased and just giving you an objective view here.

Now, while I am not, you know, an expert in public policy or in law-making, I can tell you how this issue that you are examining is affecting investment in an industry that is one of the true pillars of the new economy, telecommunications. Uncertainty is clearly the enemy of investment, and uncertainty about this issue, about paying reciprocal compensation for Internet-based services, is in my opinion raising the cost of capital, hindering investment decisions and thus slowing the growth of this industry.

Mr. Tauke mentioned something that was interesting, the expenses of Bell Atlantic occurring based on reciprocal compensation. Now, as a securities analyst, I don't really know whether these expenses are going to go up, if they are going to go down; and that means that my view of the predictability of Bell Atlantic's investment plan, if it wants to go out and, let's say, accelerate investment in building broadband networks to people, is challenged. I have a very difficult time.

Uncertainty equals higher cost of capital. That is what you should really focus on when you are taking a look at this issue.

Now, I do believe that we need clear and enforceable rules governing the payment for the Internet; the Internet didn't come for free, and those rules simply do not exist today.

Now, I was also planning, like some of the others, to talk a little bit about the issue itself. I think it has been pretty fully vetted here. I did want to return to something that Mr. Strickling mentioned, and that is that the rates today for the payment of reciprocal compensation for the Internet are higher than cost.

Well, if we know that they are higher than cost, I think that we should set some rules. And maybe there are some procedural or administrative issues that are at place here, and if that is so, government should empower the FCC to make some decisions, in my opinion. That would help visibility in the financial markets and, therefore, lower the cost of capital.

Now, in the complex language of securities analysis, this situation is a mess, and it really does need some clearing up; and I would encourage you to do that.

I wanted to also make two other brief observations based on some things that I have heard surrounding this issue. There seems to be a concern that ending the current system of payment of reciprocal compensation for Internet service would thwart investment in the industry—some have even said, maybe stifle investment in the industry. I would disagree with these claims. I think that the opportunities for investing in this sector are as good and probably better than they have ever been in the history of the industry.

There are tremendously good changes in technology regulation that are encouraging investment today, and particularly in the segment of the market that has historically been called the "local exchange," you know, although it is not really clear to me why we should still be using this regulatory designation of "local," which is unique in the United States, while we have a deregulated market.

But nonetheless, local has been a monopoly up until the Telecom Act. It has tremendous opportunities, given the fact that the industry is growing so rapidly, and still the incumbent carriers control a lot of it. So if I had a lot of money and if I knew something about running a telephone business, I would certainly be interested in entering that market.

No. 2, things—in terms of additional issues or concerns, I have heard that you will have conditions that go bankrupt if we end the current system of payment for reciprocal compensation for Internet. Now, this well may contribute in a small percentage of the cases to some bankruptcies—and I say "contribute"; it won't necessarily cause in total, but contribute. But it is hard for me to sit here and really justify how taxpayers should foot the bill for high-risk ventures that go under.

Knowledgeable investors are well aware of the risks associated with this current system of payment for reciprocal compensation for the Internet, and I think value securities accordingly. So while the riskiness of these revenue streams may not be known by informed speculators, it is well understood by knowledgeable investors, and the current stock prices I believe do reflect this.

So just in closing and to reemphasize this point, if you know it is a decision of the U.S. Government to start to bail out high-risk investors and speculators, let me know right now. I will go out and I will go buy options on some new issue Internet stocks and let other people bear the risks. But I do feel, in all seriousness, that is not a good idea; and I don't think that this notion that a lot of companies will go bankrupt is a fair characterization of the current environment.

Thank you very much.

[The prepared statement of Eric Strumingher follows:]

PREPARED STATEMENT OF ERIC STRUMINGHER, MANAGING DIRECTOR, RESEARCH, PAINEWEBBER INCORPORATED

Thank you, Mr. Chairman and Members of the Subcommittee, for inviting me to offer some observations on H.R. 4445. I am a securities analyst specializing in the telecommunications industry, not an expert on the law or public policy, and I am not here to recommend to you a specific course of action to remedy the industry issues that you seek to address in H.R. 4445. However, I am an experienced securities analyst in the telecommunications industry, and I can tell you with conviction that uncertainty is the enemy of investment. In my opinion, the uncertainty regarding the payment of reciprocal compensation for Internet service is raising the cost of capital for industry participants and thus retarding the growth of an industry that is one of the pillars of the new economy. The Internet does not come for free, and this industry is in need of specific, enforceable rules that will establish who will pay for it so that low cost capital can be made available to fuel its growth.

Reciprocal compensation is a framework for inter-carrier compensation governing the termination of local traffic that is mandated by the Telecommunications Act of 1996. Until 1999, there was a big controversy over the classification of dial-up Internet traffic: is it "local" traffic, and thus subject to payment of reciprocal compensation, or is it "long distance" traffic, and thus not subject to payment of reciprocal compensation? In 1999, the FCC issued an order asserting that dial-up Internet traffic uses telecommunications services that are interstate. Traffic can not be both interstate and intrastate: these are mutually exclusive jurisdictional designations. Therefore, if it's interstate, it's not local. This cleared up the ambiguity . . . or so we thought. In the same order, the FCC also gave state commissions great latitude to compel carriers to continue paying reciprocal compensation for dial-up Internet traffic. This is a logical inconsistency that I do not comprehend. Furthermore, more than half of the states have determined through regulatory proceedings that the FCC erred in its assertion that dial-up Internet traffic uses interstate, as opposed to local, telecommunications service. These events have introduced uncertainty that has increased the cost of capital in this industry. In the technical language of the financial markets, this situation is a mess.

I'd like to also address some concerns that have been raised about the impact that ending the payment of reciprocal compensation for Internet traffic would have on the industry. Some are concerned that ending the payment of reciprocal compensation for Internet traffic will thwart investment in telecommunications. In my opinion, this is the wrong conclusion. The investment opportunities in the industry brought on by the significant changes in regulation and technology are huge, with or without reciprocal compensation for Internet traffic. The opportunity to invest in facilities that connect directly to customers, a segment of the market that was historically a government granted monopoly, may be the best opportunity of all for carriers that have the industry knowledge and the management skills to seize them. Large companies such as AT&T and WorldCom and smaller companies like Allegiance Telecom and Nextlink Communications are examples of competitors that have successfully invested in this area and that are continuing to invest here. Competition in this "local exchange" segment of the industry and investment in productivity enhancing assets will not stop as a result of ending the current system of reciprocal compensation for Internet service.

There is also concern that companies will go bankrupt as a result of a change in the current system of paying reciprocal compensation for Internet service. Business plans that are based solely or in great part on receiving reciprocal compensation for Internet service are very high-risk business plans. While some businesses could have a hard time if the system of paying reciprocal compensation for Internet service was ended, I don't think that it's the government's job to bail out entrepreneurs from bad investment decisions. Informed investors realize that the sustainability of revenues generated from this source is subject to great uncertainty given the ambiguity/inconsistency of the current regulations. It has been clear for years to knowledgeable entrepreneurs and investors that reciprocal compensation for Internet service is a source of revenue that could very well go away. PaineWebber financial advisors and professional investors managing large sums of money have been made well aware of these issues, and I can tell you that companies relying heavily on revenue from reciprocal compensation for Internet service are having a much harder time raising money today than they were several years ago. Private and publicly traded competitive local exchange carriers (CLECs) command lower valuations than their peers to the extent that they have a higher percentage of total revenue and profit represented by reciprocal compensation for Internet service.

Mr. TAUZIN. Thank you very much.

Indeed, we also requested someone to represent the ISP community, and recommended to us was Mr. Chad Kissinger, President of On Ramp Access Inc., of Austin, Texas.

Welcome Mr. Kissinger.

I will point out to my friend, Mr. Markey, I don't think there is any relationship to the other famous Kissinger.

STATEMENT OF CHAD KISSINGER

Mr. KISSINGER. Unfortunately not. Thank you, Mr. Chairman and members. Again, my name is Chad Kissinger. I am the President of On Ramp Access, Inc., the local Internet service provider in Austin Texas. We provide service in all the big cities in Texas. I also the immediate past president of the Texas Internet Providers Association, which is the largest and most active ISP association in the United States.

I would like to tell you a few things before I get into my four points. I know on a first-name basis well over 100 ISPs, and I have never, ever heard of an ISP getting a kickback from a CLEC for reciprocal compensation. I have certainly never received a kickback for a reciprocal compensation; it has never been offered. I have asked for it, because it sounds like a good idea, but I have never been offered it.

I also am not against a CLEC. Out of those 100-plus people that I know that are ISPs, I know of one that has become a CLEC. He became a CLEC because a CLEC bought him. So the idea that we are all becoming CLECs to garner reciprocal compensation, I don't think is quite accurate.

First of all, my testimony today will cover a few points. The first point is that it seems to me that the ILECs are protesting a little bit too much about the expense of the Internet and the expense that the reciprocal compensation is costing. The ILECs have benefited greatly from the proliferation of the Internet. They are signing up more and more telephone lines in businesses and in homes. Homes are adding second telephone lines in their homes so that they can connect to the Internet and still receive calls from their neighbors. In fact, Mr. Tauke mentioned annual reports; in SBC's 1999 annual report, on page 8, they talk about how they—39 percent of their increased demand in 1999 was for access lines, was due to second and third telephone lines put in the houses that already have telephone lines. That 39 percent increased demand in 1999 resulted in, according to my calculations of the numbers on that page, in $480 million of new revenues. That is on top of the revenues that they had got even from new lines installed in 1998 because of the Internet in 1999, 1998, 1997, 1996, 1995, 1994, and that is only the residential customers. That doesn't count the businesses that are adding telephone lines.

Much further back in the annual report—I am sorry I don't have the page reference with me—you will find that they say that Internet calls are costing them $288 million in reciprocal compensation. So in 1999 they have received billions and billions of dollars of new revenues generated specifically to serve Internet calls, and they have only paid out a few hundred million dollars in reciprocal compensation. I think they protest a little bit too much.

If you understand the economics of how this network works—and I will be glad to expand upon that a little bit later if you would like—if you understand how the economics of this work, the CLECs are the people that are building the Internet and incurring the cost. The CLECs are the people that are trying to offer services, that are digging holes in the streets and puting out fiberoptics to ISPs like myself.

Which brings me to my second point. I know right now I pay 3 percent less for my telephone lines than I pay—because I buy them from a CLEC, than I would pay if I bought them from Southwestern Bell, pay 3 percent. That is not a hard sell if Southwestern Bell really, truly wanted my business. If they wanted my business and were to come out and offer me quality service, they would have it. I have no preference to buy service from Time Warner or ICG, other than—rather than Southwestern Bell.

But Southwestern Bell is obstructionist. They are one of my competitors; they are competing with me in the marketplace, and they would like to monopolize the marketplace for Internet traffic. They do not participate in the market for Internet service providers' business. We are here; come get us. That is a good way to eliminate reciprocal compensation, have the ILECs come get our business; no payments will occur.

The third point that I would like to bring up is kind of talk about that monopoly station, the fact that I think will occur if we eliminate reciprocal compensation. You would think that these ILECs would want to deregulate the cost, the floor costs, of their services so that they could go out and compete better against the CLECs and get some of our business back and eliminate all of this reciprocal compensation. In fact, in 1995, Southwestern Bell came into our legislature in Texas and help pass a bill called Senate Bill 560, which helped alter the prices of telephone lines offered to Internet service providers.

But you would think they would try to alter the floor; they didn't. They eliminated the ceiling. Right now, in Texas, Southwestern Bell—it is legal for them with 24 hours' notice to the Public Utility Commission to change the prices for a telephone line to an Internet service provider to any price they want. They can charge a billion dollars per telephone line to us if they want.

So if we eliminate reciprocal compensation and Time Warner and ICG stop drilling trenches out to my building and stop hauling fiber up into my suites and stop trying to get my business, I have no hope that Southwestern Bell is going to all of a sudden show up and change heart and try to get my service.

The last point I would like to bring up is that it seems kind of strange that the ILECs are making the argument that Internet traffic is not local, that it is long distance in nature. Well, if it is long distance in nature, how are they running Internet service providers? How are they competing with me? It is against the law for them, except in New York in Bell Atlantic's case, to offer long distance service.

Repeatedly, when we hear them testify on access charges, they argue that a call is a call. And a call terminated across a telephone line for long distance service is the equivalent of a call terminated across the Internet for long distance service. If that is the case, why are they in the business? Why are we allowing them to be in the business?

I am all for you ruling that it is a long distance call, and that will get them out of the Internet business and let us compete for that business.

That is the conclusion of my remarks.

Mr. TAUZIN. Thank you.

Finally, we welcome Mr. Bob Taylor, the Chairman of the Association for Local Communications, a CLEC, facilities-based—and the Association is primarily and completely, I think, a facility-based CLEC; is that right—Mr. Taylor, for your testimony here, sir.

STATEMENT OF ROBERT TAYLOR

Mr. TAYLOR. Thank you, Mr. Chairman and members of the committee. My name is Bob Taylor; I am President and CEO of Focal Communications. I also appear as the Chairman of ALTS, the Association for Local Telecommunications Services. I welcome the opportunity to explain why I think H.R. 4445 is unnecessary and also anticompetitive.

The act in 1996 was a tremendously important piece of legislation and this committee really led the forefront into making it happen. As a direct result of that, CLECs have invested and built over $30 billion of new assets. Our revenues have exploded, going from less than a billion dollars before the act to about $6.3 billion in revenues last year. Real competition is happening, and the act jump-started that.

But H.R. 4445 really would reverse the aspects of local competition. And let me give you sort of my five points as to why I think that.

First, there is a cost to building this business. The $30 billion is an investment that has been raised on Wall Street, raised through private investors; there needs to be a just return for them. When we provide service, whether it is to an ISP, to a residential customer—of which Focal will have hundreds of thousands of residential customers up and running across the country in the next 12 months; we have tens of thousands today, as well as all three branches of the Federal Government buy service from us—there is simply a cost to providing that service.

Just as the Bell companies deserve compensation for one-way traffic from wireless providers, CLECs deserve compensation for the traffic that they terminate. Eliminating reciprocal compensation is really an unjust taking of property.

Second, it will cause great harm to the Internet. As Mr. Kissinger pointed out, CLECs are putting in the fiber, putting in the infrastructure that is used by most of the ISPs today. It is simply the point that we provide good service. There is no cost advantage, no price difference, between our service and the Bells. In fact, many of the Bell companies buy Internet access from CLECs in their out-of-territory markets because it is better.

We have built a better network with better technology, and we provide a better service; and if we eliminate reciprocal compensation, the cost of that service will go up. In my written testimony Peter Engdahl indicated that his customers would have to pay more than $6 a month for their Internet service bills. So there is a cost and it will be borne by the ISP user, the AOL user, if reciprocal compensation goes away.

Third, the Bell companies came up with this idea. I mean, you know—we, as the CLECs, you know, don't want high rates. In fact, we have been working to drive these rates lower. It is something that when we started out in this industry, as many of you pointed out, bill and keep was the direction that the CLECs wanted and that many, including Bell Atlantic, fought hard for reciprocal compensation.

Well, being business people, we couldn't fight the process forever; we had to take the rules that were given to us, and we think we have made a good business decision. Most State regulators agree, as it has been pointed out—15 States have pointed out that since this issue has been addressed in arbitration cases, that reciprocal compensation should be paid for Internet traffic. In fact, as Mr. Dingell pointed out of the relatively astute horses in North Carolina that have been using the Internet for some time, the North Carolina PUC was very astute in making sure that that type of sham Internet service provider, sham organization, didn't get compensated.

By all means, Mr. Chairman, we are against the sham ISP. We share your concern and we would love to work with you and your staff to make sure that doesn't happen. But by and large, that is far and few between, and we think that is the exception not the rule.

Finally, on the fourth point, reciprocal compensation rates are going down. As Mr. Tauke pointed out on his charts of $18 a month, we see reciprocal compensation rates today that are 10 percent of what they were when we started out. When we built Focal in 1996, we were seeing reciprocal compensation rates in excess of a penny a minute. Again, we didn't set those rates, the Bell companies told us, here are the rates.

Today, we are seeing reciprocal compensation rates of a tenth of a cent a minute. That is where it should be going.

I think everybody has agreed that there is a cost. We think that this should get to the cost, and the Bell companies are the ones that set the rate, not us. They could have set this at a tenth of a cent a minute 4 years ago; they chose and, in fact, in New York, over a penny a minute because they were not recipients and they were playing the same game with the wireless service providers.

And finally the FCC and the States are really the proper bodies to resolve any issues regarding this. As it was pointed out, 33 States have ruled that CLECs should receive reciprocal compensation payments and five States have ruled otherwise. Whether or not you would agree with these results, it is clear that the States have the ability, the knowledge; and the Bell companies have made very well and very poignant argument that they should not have the obligation to pay it, yet 33 States have said they should.

So, really, it is the FCC that is all about—is considering its decision on reciprocal compensation; and virtually all of the members of this committee have asked them to do that.

We support the chairman and the committee members in having the FCC relook at this, and focusing it back where it belongs, in the hands of the regulators who have the ability to make the right decision.

Thank you very much.

[The prepared statement of Robert Taylor follows:]

PREPARED STATEMENT OF ROBERT TAYLOR, CHAIRMAN OF THE ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES, AND CEO, FOCAL COMMUNICATIONS

Thank you Mr. Chairman and members of the Committee. I welcome the opportunity to appear here today on behalf of the facilities-based local telephone competitors to explain why H.R. 4445 is unnecessary and anti-competitive, and to show why the '96 Act will continue fostering local telephone competition and consumer welfare without any amendments.

The '96 Act was the most important piece of telecommunications legislation passed by Congress in sixty-two years, and this Committee led the way. Thanks to the '96 Act, the competitive local telecom industry has raised the capital to build over thirty *billion* dollars of local infrastructure, the competitive "bricks and mortar" that mean lower prices and new choices for local telephone consumers.[1] Local revenues for competitive local exchange providers ("CLECs"), have exploded from less than one billion dollars in 1996 to more than 6.3 billion dollars in 1999, access lines have climbed from approximately one million in 1996 to over 10 million in 1999,[2] and CLEC employees now exceed 70,000.[3] Of course, the competitive industry would prefer to move even faster, but it is manifest that the '96 Act has jump-started competition in local telecom markets.

With that background, let me turn to the subject of today's hearing—reciprocal compensation. Inter-carrier compensation is necessary in competitive local markets because the carrier serving an end user making a local call may be different from the carrier serving the called party. Since terminating carriers receive no additional revenue from end users for completing local calls, the '96 Act requires originating carriers to compensate terminating carriers for their variable costs. This inter-carrier payment is called "reciprocal compensation."

Reciprocal compensation applies anytime one carrier originates a call and another carrier terminates a call. So, reciprocal compensation applies to cellular calls that originate on a cellular carrier's network and terminate on a landline network. In this case, the cellular company compensates the ILEC for its costs of terminating the call. The same is true for local voice phone calls. If a call originates on an ILEC network and terminates on a CLEC customer, the ILEC compensates the CLEC. And vice versa if the call originates on the CLEC network and terminates on the ILEC network. Finally, the same regime applies to calls to the internet. If the call is originated by an ILEC customer and terminates on a CLEC network to an Internet service provider (ISP), the ILEC compensates the CLEC.

Incumbent local telephone companies complain these rates were set too high in the first round of contracts that were concluded between the RBOCs and new entrants in '96 and '97 following passage of the Act. These contracts usually last for three years. According to the RBOCs, the '96 Act cannot be trusted to reduce these rates to the actual costs of terminating local traffic in the next round of contracts, so they propose to totally eliminate these charges in subsequent contracts for one category of traffic—calls to Internet service providers ("ISPs").

SUMMARY OF ALTS' AND FOCAL'S OPPOSITION TO H.R. 4445

H.R. 4445 would prohibit all reciprocal compensation payments for carriers that terminate calls to the internet. ALTS and Focal Communications strongly oppose this legislation for the following reasons:

First, prohibiting competitive telecom providers from receiving payment for terminating calls to the internet is anti-competitive and possibly unconstitutional. Competitors incur costs of carrying these calls, and we deserve to be compensated for these costs. *Second,* if competitors are not allowed to receive compensation from the originating carrier, we may have to attempt to recover these costs from the Internet provider. The internet provider may then be forced to flow those rate increases through to its customers. Thus, **eliminating reciprocal compensation could cause rate increases for thousands of internet consumers.** *Third,* it was the RBOCs, not the CLECs, who supported high reciprocal compensation rates three years ago. *Fourth,* the negotiation and arbitration of successor ILEC/CLEC contracts pursuant to the '96 Act is already moving reciprocal compensation rates down. Some recent contracts have reduced reciprocal compensation rates by over half. Thus, there is no need to amend the '96 Act to make sure this will happen. *Fifth,* if any fine-tuning of reciprocal compensation rules for ISP-bound traffic were needed, it

[1] *The State of Competition in the U.S. Local Telecommunications Marketplace,* ALTS Annual Report, February 2000, Graphic F.
[2] *Id.* at Graphics I and J.
[3] *Id.* at Graphic F.

would be far better accomplished by the FCC and the states than through legislation.

1. CLECs incur costs for carrying internet calls, and thus deserve to be compensated for providing this service to Internet Service Providers.

Inter-carrier compensation among telephone companies wasn't needed when American telecommunications was still a monopoly in the early "80s. All toll and most local calls were completed by a single carrier, the Bell System, which owned the long distance operations of AT&T, as well as the Bell operating companies.[4]

This changed radically with the emergence of long distance competition. Not only did the local Bells lack common ownership with new long distance competitors like MCI and Sprint, they also lost their common ownership with AT&T when the Bell System was split up on January 1, 1984. The advent of unaffiliated long distance carriers forced the FCC to create an inter-carrier compensation mechanism because the long distance carriers collected all toll revenues even though the originating and terminating local companies (usually two separate carriers) also incurred costs when they carried toll traffic between end user locations and the interchange carriers' facilities. At the request of the local Bell operating companies, the FCC created the "access charge" system to ensure originating and terminating local carriers were fully compensated by long distance carriers.

The emergence of wireless communications in the '80's, and the increasing exchange of calls between wireless carriers and the RBOCs, required the creation of a second Federal inter-carrier compensation mechanism. Traffic tended to flow from wireless carriers to the wireline companies, so some wireless companies argued that the inter-carrier compensation rate should be zero (a zero rate means the originating carrier does not share any of its billed end user revenue with the terminating carrier, and is often referred to as "bill and keep"). But the RBOCs insisted they had to be compensated for transporting and terminating this traffic, and argued vehemently that "bill and keep" would violate the Fifth Amendment's prohibition against the "taking" of private property.[5] The FCC agreed with the RBOCs, and ordered reasonable compensation for the transport and termination of wireless-wireline calls.[6] Today this traffic still flows in the direction of the wireline carriers, and the RBOCs continue to collect substantial amounts for transporting and terminating wireless calls.

The need for a third Federal inter-carrier compensation system emerged when Congress opened America's local markets to competition in the 1996 Telecom Act. Both the Senate and House bills that became the '96 Act contained provisions requiring inter-carrier compensation for local traffic. This Committee described the requirement that eventually became Section 251(b)(5) of Title 47 as "integral to a competing provider seeking to offer local telephone services over its own facilities" (H.R. 104-204, pp. 72-73).

The FCC agreed with the RBOCs, and required the establishment of cost-based reciprocal compensation rates: ". . . we find that carriers incur costs in terminating traffic that are not *de minimis,* and consequently bill-and-keep arrangements that lack any provisions for compensation do not provide for recovery of costs" (*Local Competition Order,* CC Docket No. 96-98, August 8, 1996, at para. 1112). The FCC concluded these rates should include "the economic cost of end-office switching that is recovered on a usage-sensitive basis" (*id.* at 1057), and that such costs ranged from "$0.002/MOU to $0.004/MOU" (*id.* at 1060).

I note there is at least one point of agreement between the RBOCs and myself: It is plainly **unconstitutional** to impose bill and keep instead of reciprocal compensation, for the reasons USTA explained to the FCC back in '96:

> "Finally, mandatory bill-and-keep arrangements would run afoul of the Takings Clause to the extent they require a LEC to incur the costs of transporting and terminating another carrier's traffic without 'just compensation'."*
> * *See generally,* Ex Parte Letter of Richard Epstein to William Kennard, CC Dkt. No. 95-185 (May 15, 1996)."

This same argument was also made by Bell Atlantic, GTE, and numerous other incumbents. If bill and keep is unconstitutional in regards to the RBOCs, which enjoy many other regulated sources of revenue, it applies with even greater force

[4] Some local calls were exchanged between the Bell companies and independent local telephone companies, but there wasn't any need for inter-carrier compensation since the costs of these calls were automatically included within and recovered by the basic rates of the local phone monopolies.

[5] *See* the May 16, 1996, letter of Prof. Richard Epstein in FCC Docket No. 95-185, on behalf of USTA.

[6] *Implementation of Sections 3(n) and 332 of the Communications Act, Regulatory Treatment of Mobile Services,* Second Report and Order, 9 F.C.C. Rec. 1411, 1497-98 (1994).

for CLECs, which have no embedded monopoly markets or other revenue streams to fall back upon.

2. Eliminating Reciprocal Compensation could harm Internet consumers.

If reciprocal compensation were prohibited for Internet traffic, it will have significant and harmful effects on the internet marketplace.

a. As stated above, CLECs incur costs of carrying calls to ISPs. If CLECs cannot receive payment for carrying these calls from the ILEC, the CLEC will have to seek payment from someone else, most likely the ISP itself. The ISPs may have to flow through this cost increase to their consumers. Cost-based reciprocal compensation ranges around $3-$6 a month for a average household using the Internet, who pay an average of about $17 a month. Flowing those costs through to end users would thus mean an *18%-35%* increase in the monthly cost of access to the Internet via CLECs.

b. Another alternative is that, if CLECs cannot be paid for providing this service to ISPs, CLECs may simply exit the market altogether. ISPs would be forced to return to receiving service from the incumbent telephone company, effectively remonopolizing the local market.

c. Finally, eliminating reciprocal compensation could force consumers to have to make long distance telephone calls to obtain access to their internet provider. One of the substantial benefits that CLECs provide to ISPs is that CLECs allow the ISP to use a local phone number. If the CLECs exit the market, ISPs may not be able to receive local telephone numbers from the incumbent. Forcing consumers to pay long distance charges on top of their higher internet charges could make internet access unaffordable for many consumers.

As this Committee is well aware, the Internet has become a huge engine of economic growth in America. Passage of legislation that either forces ISPs back to the monopoly providers, or else increases the cost of Internet access for millions of Americans by 18% to 35% is terrible public policy, pure and simple.

3. It was the RBOCs, not the CLECs, who supported high reciprocal compensation rates three years ago.

When the FCC requested comments on how it should implement Section 252(b)(5) of the Communications Act, the RBOCs supported reciprocal compensation and opposed “bill and keep.” According to Bell Atlantic:

> The most blatant example of a plea for a government handout comes from those parties who urge the Commission to adopt a reciprocal compensation price of zero, which they euphemistically refer to as ‘bill and keep.’ A more appropriate name, however, would be ‘*bilk* and keep,’ since it will bilk the LECs’ customer out of their money in order to subsidize entry by the likes of AT&T, MCI, and TCG . . . [A] regulatorily mandated price of zero—by any name—would violate the Act, the Constitution, and sound economic principles” (emphasis in original; BA Reply Comments in 96-98 at 20).

Bell Atlantic also pointed out that reciprocal compensation would apply to ISP-bound traffic (*id.* at p. 21).[7]

As noted earlier, the FCC initially proposed that the rates for reciprocal compensation should fall in the range of $0.002 to $0.004 per minute of usage. However, the RBOCs succeeded in obtaining a stay of the FCC’s *Local Competition Order* in the Fall of 1996. This enabled the RBOCs to demand much higher reciprocal compensation rates—around $0.008/MOU to .0009/MOU—believing they would terminate more traffic than they would send to the CLECs. The CLECs had to obtain signed agreements from the RBOCs quickly in order to start requesting unbundled elements, interconnection, and the other facilities that they needed from the RBOCs to begin their businesses. Consequently CLECs had no choice except to accept the high rates demanded by the RBOCs rather than risk delay by litigating the issue.

[7] *See* Appenidix B. Bell Atlantic subsequently claimed its 1996 statement was not an admission that calls to ISPs were local calls. According to Bell Atlantic, the statement assumed that calls to ISP were long distance calls, and that the access charge regime for long distance calls would be replaced by reciprocal compensation instead. But Bell Atlantic *opposed* replacement of access charges by reciprocal compensation elsewhere in the same document (at pp. 4-6), and contended the long distance companies’ arguments were only “lip service” because the proposal was already dead (*id.* at p. 40). Accordingly, it is not credible that Bell Atlantic would silently assume the adoption of a proposal it had opposed so strongly and treated as so unlikely just 16 pages earlier in the same document.

4. The CLECs have out-competed the RBOCs in the marketplace. Congress should not consider legislation that would overturn this free market result.

As stated earlier, Bell Atlantic had predicted to the FCC in May of 1996 that the CLECs would start pursuing in-bound traffic if reciprocal compensation rates were set too high—a prediction that proved far more prescient that Bell Atlantic could have anticipated.[8] As the CLECs began to offer service three years ago, the Internet providers were among the first customers to recognize the benefits of the CLECs' new technologies. The ISPs realized that the CLECs provide better overall value—the combination of price and service.

The important service factors for ISPs are: installation intervals and order accuracy, repair response time and effectiveness, cost-effective colocation, and minimal call blocking. The ISP industry consistently ranks the CLECs ahead of the RBOCs on each of these service parameters, and continues to award CLECs with most of the growth in ISP lines even though the ILECs now charges basically the same price. Indeed, a CLEC like Focal has been so successful at meeting these needs in comparison to Ameritech that about one-third of the dial-up traffic to ISPs in Chicago is carried by Focal.

Of course, the key point here is not to praise the job being done by CLECs, but rather to point out that the RBOCs obviously have the financial and technical resources to provide the same services to ISPs that CLECs provide—but have chosen not to do so. Nothing stops Ameritech from meeting or beating Focal's ISP services, and ending the traffic imbalance. Taking just the example of call blocking, Focal has made a major investment in interconnection with numerous Ameritech end offices to ensure calls don't get blocked if an individual office unexpectedly reaches its capacity, and starts blocking calls. Ameritech has provided phone service in Chicago for over a hundred years, and could easily provide the same guarantee against call blocking. But it does not. I don't question that Ameritech has the right to make that business decision, but I do think it clearly demonstrates the current traffic imbalance between ILECs and CLECs is not the result of a policy problem, but rather the result of the RBOCs own preference to forego competing for ISP traffic.

In short, the CLECs out-competed the RBOCs the in the marketplace by providing better service to the ISPs. Having lost in the marketplace, the RBOCs should not be permitted to undermine this marketplace result through legislation.

5. Reciprocal compensation rates are rapidly declining.

Although the 8th Circuit's stay of the FCC's rules prevented implementation of cost-based reciprocal compensation in the initial interconnection contracts, the Supreme Court's reversal of the 8th Circuit has reinstated those rules in time to control the negotiation and arbitration of subsequent interconnection contracts (the initial contracts usually lasted about three years).

The application of the FCC's rules by the states is clearly moving rates down toward cost. For example, the New York Public Service Commission determined last August that the proper rate for terminating ISP-bound traffic should be one-third of a cent per minute, a reduction of more than sixty percent from the nine-tenths of a cent ($0.009/MOU) rate that had applied. Bell Atlantic did not appeal that order. And earlier this year the Illinois Commerce Commission cut reciprocal compensation rates by almost one-half. Needless to say, the RBOCs submitted extensive witnesses and evidence in each of these proceedings in support of a reduced rate.

Negotiated settlements reveal the same trend. While the rates contained in settlements are obviously driven by the needs of the particular carriers involved and do not necessarily reflect economic cost, several CLECs have recently announced settlement agreements with Bell Companies that reduce their reciprocal compensation rates substantially, sometimes to 10% of the former rate level.

6. The Federal Communications Commission and state regulatory commissions should continue to address reciprocal compensation issue.

The FCC is currently examining the issue of reciprocal compensation for ISP-bound traffic. Upon requests from several parties, the FCC addressed the issue of reciprocal compensation for ISP-bound traffic in a February 26, 1999, Order. First, it concluded that calls to ISPs are interstate as a *jurisdictional* matter. Second, it investigated the particular interstate *service* involved (are interstate calls to ISPs local, or are they interstate access; i.e., the access portion of interstate long distance calls?). While the RBOCs had tried to confuse the issue of jurisdiction with the issue

[8] Appendix B.

of service category,[9] the fact that a call is interstate jurisdictionally does not automatically make it a long distance call. The FCC needed to resolve this service category issue because long distance calls are not covered by the reciprocal compensation rules for local traffic inasmuch as long distance calls are already covered by the access charge inter-carrier compensation mechanism.[10]

The FCC concluded that ISP-bound calls constitute the access portion of long distance calls, and thus were not subject to the reciprocal compensation rules for local traffic. The FCC went on to propose creating Federal inter-carrier compensation rules for ISP-bound traffic, noting there are costs for transporting and terminating this traffic, and held that until these Federal rules became effective, states could supervise all aspects of inter-carrier compensation for ISP-bound traffic, including enforcement of existing contracts.

CLECs appealed the FCC's determination that ISP-bound traffic was not local, but the FCC's jurisdictional finding was not challenged. The D.C. Circuit agreed with the CLECs, and vacated this determination. According to the Court, the FCC had failed to explain why jurisdictional precedent had any application to the service category issue, where the correct question is: ". . . discerning whether a call to an ISP should fit within the local call model of two collaborating LECs or the long-distance model of a long-distance carrier collaborating with two LECs".[11]

The FCC has not yet requested public comment concerning the vacation and remand of its finding that ISP-bound traffic is access traffic. CLECs believe the FCC will have to conclude in its remand that ISP-bound traffic is clearly local, given the Court's articulation of the service category test.

If the FCC concludes this traffic is local, then its reciprocal compensation rules automatically apply. However, if the FCC concludes this traffic is actually exchange access, then it will not be covered by the reciprocal compensation rules, nor will it be included within the access charge regime because the FCC's policy that such calls not pay access charges.[12] I expect the FCC to formulate inter-carrier compensation rules for this traffic segment, since the Commission clearly believes there are terminating costs involved. I have no reason to believe that the FCC's ultimate inter-carrier compensation rules for ISP-bound traffic would differ from the cost-based rules that already apply to all other local calls. However, the delay and contingencies associated inherent in constructing a new inter-carrier compensation might raise questions in the mind of the investment community about the ability of CLECs to recovery their terminating costs. Thus, there is also a serious policy problem in treating ISP-bound calls as access, in addition to the underlying legal issue.

Furthermore, the state regulatory commissions have taken the bull by the horns and are actively ruling on reciprocal compensation agreements. As of today, thirty-eight states and twelve federal courts have heard the arguments on both sides, and none has been persuaded that they actually intended to exclude internet traffic from the initial interconnection agreements.[13] The record clearly demonstrates that reciprocal compensation rates are already coming down through the states' application of the FCC's existing rules for cost-based reciprocal compensation rates.

7. Conclusion

In conclusion, it is clear that reciprocal compensation rates are declining through private negotiations among the carriers. Eliminating reciprocal compensation altogether, as proposed by H.R. 4445 would be unconstitutional, would deny CLECs the ability to recover their costs of providing service to internet providers, and could cause substantial harm to internet consumers. There is simply no need for Congress to interrupt these trends through legislation such as H.R. 4445, or by creating yet another inter-carrier compensation mechanism.

[9] The RBOCs still attempt this confusion; *see* USTA's May 3, 2000, letter in FCC CC Docket No. 96-98.

[10] *Local Competition Order* at para. 1034: ". . . in the access charge regime, the long distance carrier pays long-distance charges to the IXC, and the IXC must pay both LECs for originating and terminating access service. By contrast, reciprocal compensation for transport and termination of calls is intended for a situation in which two carriers collaborate to complete a local call."

[11] Slip opinion at p. 11

[12] This Committee and the full House last month adopted ,The Internet Access Charge Prohibition Act of 1999, which codifies the FCC's policy.

[13] *See* Appendix A to this testimony. The conclusion of the Ohio Public Utilities Commission is typical: conclusion as the Ohio PUC: ". . . a review of the interconnection agreement reflects that the parties were very specific in identifying services that were not subject to reciprocal compensation. Had Ameritech truly believed that ISP traffic was exchange access traffic [i.e., not local traffic] at the time the interconnection agreement was negotiated, Ameritech should have identified it as such" (Case No. 97-1557-TP-CSS, August 27, 1998, at 9).

Once again I want to thank the Committee for its leadership in introducing competition into local telecommunications markets. The '96 Act is working to foster fair, cost-based competition, and it should be allowed to continue working.

APPENDIX A: State and Court Orders Upholding

Reciprocal Compensation for ISP-Bound Traffic as of June 14, 2000

	Initial ILEC-CLEC Contracts		Subsequent Arbitrations	Court appeals
	Pre-FCC ruling	Post-FCC ruling		
Alabama		Yes	Yes	Yes
Arizona	Yes		No	
Arkansas	Yes			
California	Yes	Yes	Yes	
Colorado	Yes		No	
Connecticut	Yes			
Delaware		Yes		
Florida	Yes	Yes	Yes	
Georgia	Yes	Yes	Yes	Yes
Hawaii	Yes	Yes		
Illinois	Yes		Yes	Yes + Yes*
Indiana	Yes	Yes		
Kentucky		Yes	Yes	
Louisiana		No	No	
Maryland	Yes			Yes
Massachusetts	Yes	No		
Michigan	Yes			Yes
Minnesota	Yes	Yes		
Missouri	Yes	?**	?	
Nebraska	Yes	Yes		
Nevada			Yes	
New Jersey		No		
New Mexico			Yes	
New York	Yes	Yes	Yes	
North Carolina	Yes	Yes	Yes	
Ohio	Yes	Yes		
Oklahoma	Yes			Yes
Oregon	Yes	Yes	Yes	Yes
Pennsylvania	Yes	Yes	Yes	
Rhode Island		Yes		
South Carolina			No	
Tennessee	Yes	Yes	Yes	Yes
Texas	Yes		Yes	Yes + Yes
Utah	Yes			
Virginia	Yes	?	?	
Washington	Yes	Yes		Yes + Yes
West Virginia	Yes	Yes	Yes	
Wisconsin	Yes			
Totals	29-0	20-3	15-4	12-0

* "Yes + Yes" indicates both the district court and the court of appeals affirmed that reciprocal compensation applies to ISP-bound traffic.

** "?" indicates an unclear ruling.

APPENDIX B: ILEC COMMENTS IN FCC DOCKET

No. 96-98 Concerning Reciprocal Compensation

Ameritech Reply Comments filed May 30, 1996:

"These parties misapprehend that the period during which new carriers first enter the local market will be the time when the traffic is most unbalanced between these new entrants and the incumbent LECs. Presumably, the traffic will become more balanced as new entrants become established in the local marketplace. A reciprocal compensation mechanism will then naturally evolve into a system where payments on one side cancel out the other. But the possibility that competition may someday reach the equivalent of bill-and-keep is no reason to ignore the traffic imbalance that will likely occur at startup."

"Given the fundamental axiom that prices must reflect actual costs for economic efficiency to be achieved, mandatory bill-and-keep would be economically inefficient. Bill-and-keep arrangements may lead to overconsumption and underinvestment even in situations when traffic is balanced."

Bell Atlantic Reply Comments filed May 30, 1996:

"The most blatant example of a plea for a government handout comes from those parties who urge the Commission to adopt a reciprocal compensation price of zero, which they euphemistically refer to as "bill and keep." A more appropriate name, however, would be "*bilk* and keep," since it will bilk the LECs' customers out of their money in order to subsidize entry by the likes of AT&T, MCI, and TCG. As we demonstrated in our opening comments, a regulatorily mandated price of zero—by any name—would violate the Act, the Constitution, and sound economic principles. *See* Bell Atlantic Br. at 40-42."

"Indeed, the proponents of bill and keep appear to recognize the flaws in their proposal, and shift their focus here to arguing that the FCC should mandate bill and keep as an "interim" pricing mechanism, and as a default price when parties do *not agree to a different rate*. AT&T Br. at 69; MCI Br. at 52-53; TCG Br. at 83-84.*

* Some parties also have suggested that the cost to terminate calls during off-peak periods is very low, and that setting prices at zero during those periods is close enough. In reality, while setting different peak and off-peak prices may make sense in some contexts, here it would merely encourage providers to find ways to modify their traffic flows—and thereby effectively change the peak—in order to take advantage of the zero rates while forcing LECs to incur peak load costs. Under these circumstances, peak and off-peak users must share the costs of capacity, and it would be irrational to set a price of zero during *any* period. *See* Kahn, *The Economics of Regulation*, Vol. 1 at 91-93."

"This will create a "threat point," so the argument goes, that will encourage LECs to negotiate reasonable rates for reciprocal compensation. But whether they are termed interim or permanent, mandatory bill and keep arrangements suffer from the same flaws, and simply cannot be squared with the Act's mandate that LECs be permitted to recover their costs absent a voluntary waiver of that right. Bell Atlantic Br. at 42. Nor will adopting bill and keep as a mandatory solution encourage parties to negotiate a reasonable price. It will do the opposite. So long as competitors know that they can get a zero rate if they do not agree to something else, the result will be bill and keep in every case."

"Moreover, the notion that bill and keep is necessary to prevent LECs from demanding too high a rate reflects a fundamental misunderstanding of the market. If these rates are set too high, the result will be that new entrants, who are in a much better position to selectively market their services, will sign up customers whose calls are predominantly inbound, such as credit card authorization centers and internet access providers. The LEC would find itself writing large monthly checks to the new entrant. By the same token, setting rates too low will merely encourage new entrants to sign up customers whose calls are predominantly outbound, such as telephone solicitors. Ironically, under these circumstances, the LECs' current customers not only would subsidize entry by competitors, but would subsidize low rates for businesses they may well not want to hear from."

GTE Comments filed May 16, 1996:

"FCC adoption of a Bill and Keep mandate would also violate the Fifth Amendment by requiring interconnection—physical occupation and use—of the LEC's network without just compensation. There can be no doubt that mandated interconnection is physical occupation of the ILEC's network. Mandatory interconnection involves not only *interconnection with*, but *carriage upon,* the existing ILEC network. Thus, there is the *physical taking* of an ILEC's property by other local service providers being granted mandatory access to, and carriage over, (limited capacity) closed transmission paths. By governmental fiat, the ILEC has no alternative but to open its network to use by another carrier. The other carrier's signals are transmitted *on* the ILEC's network. These signals *physically occupy* the ILEC's network in the same manner that a property owner having an easement for ingress and egress may physically occupy the drivepath of an adjacent property owner in order to traverse the space from his home to a public roadway. In each instance, the servient tenement—be it adjacent property owner or ILEC—must be compensated." [Emphasis in the original]

USTA Comments filed May 16, 1996:

"Finally, mandatory bill-and-keep arrangements would run afoul of the Takings Clause to the extent they require a LEC to incur the costs of transporting *and terminating* another carrier's traffic without 'just compensation.'*

* *See generally,* Ex Parte Letter of Richard Epstein to William Kennard, CC Dkt. No. 95-185 (May 15, 1996)."

"The Commission must have a "clear warrant" to adopt an interpretation of a statute that effectuates a taking.** As stated above, the Commission not only lacks a clear *warrant to mandate* bill and keep under the Act, but lacks *any* authority to do so.

** *See Bell Atlantic Tel. Cos. v. FCC,* 24 F.3d at 1445; *see also Rust v. Sullivan,* 500 U.S. at 190-91."

APPENDIX C: REMARKS OF PETER ENGDAHL OF SNOWCREST

I. Introduction

A. Name: Peter Engdahl

B. President of SnowCrest, Inc. an Internet Provider, family founded and run.

C. SnowCrest, Inc. was started in late 1994 in rural Northern CA and was the first company to offer Internet service to towns like Mt. Shasta, Weed, Happy Camp, Weaverville, and many others. In many of these areas we remained the only Internet provider for two years. The areas we serve range from around 100 people to at most 10,000 with the only large area being Redding with 60-70k people.

II. Changing from an ILEC to a CLEC

A. SnowCrest, Inc. began business with the local ILEC(Pac Bell) and continued with them for approx. two years. After the 1996 telecommunications Act allowed for competition we began looking at the possibility of moving much of our infrastructure over to a CLEC.(specifically Pac West). We decided to switch and have been with Pac West since 96/97.

B. We chose a CLEC due to several reasons:

1. There were more innovative services offered by the CLEC. (Ie. Co-location of equipment inside of the switchroom, purchase of outside local POPs from a central location). Co-location of equipment offered us the ability to lower costs by reducing the distance the necessary phone lines had to travel between the phone company and our equipment and offered easy access for repair and maintenance. The CLEC, by allowing ISP's to purchase local access numbers from other towns while still having our equipment in a single location, allowed us to significantly lower our costs and provide the same new technologies and speeds to rural areas as well as urban. Note: The Incumbent could offer these services and compete with the CLEC instead of seeking federal policy changes, but they have choosen not to.

2. The ILEC is incapable(or unwilling) to fulfill orders by due date or correctly fulfill orders. The CLEC almost always fulfills order correctly by the due date. Comparison: we have found that ordering a line that takes the ILEC 30 days to complete and will require another 1-3 weeks to repair from improper installation/programming will take the CLEC 7-10 days to install and if installed incorrectly 1 day to repair.

3. We were told by the ILEC they were unwilling to add more services in cities that we needed to expand in unless SnowCrest, Inc. payed the ILEC for the installation of their infrastructure to service those areas. Currently the ILEC's are complaining that the CLEC's have focused upon ISP's as their customers. However, many ISP's such as ourselves were more than willing to leave the ILEC's who did not want us or even bother to offer us competitive services.

II. Reciprocal Compensation

A. The reason for Reciprocal Compensation

1. Although Reciprocal Compensation is explained in greater detail by the CLECs I will voice my observation that if traffic from an ILEC is passed to a CLEC no matter what kind of traffic it is, it is the right of the CLEC to expect and be guaranteed payment for that service from the ILEC.

B. If Reciprocal Compensation Were Eliminated

1. Those ISP's receiving service through CLEC's would be billed for the CLEC's cost of terminating the call. The reason the ISP's would be billed is because there is currently no other structure for the CLEC's to collect compensation from the ILECs for the cost they are incurring on the CLEC's equipment. This would force ISP's to either raise their rates accordingly or move from the CLEC.

2. If SnowCrest, Inc. were to stay with the CLEC our rate increase would be about $6 per user which would take us from $15 per month to $21 per month(this is based on an average user load of 53 hours per month and multiplying by 2/10 of a cent). The cost for terminating a call has been estimated at 2/10 of a cent per minute. As we are mostly a rural provider a great number of our users are fixed income or low income and would not be able to make this jump. Therefore

SnowCrest, Inc. would be forced to drop the CLEC and either move back to the ILEC(which the lack of services they offer would at this point make that move impossible) or have to "piggy-back" our service onto a larger Internet wholesaler. "Piggy-backing" on an Internet Wholesaler would not offer the same coverage of local access numbers in rural areas and so would leave some areas completely without local access to the Internet.

3. There would be a distinct reduction in choice of ISP's if reciprocal compensation were eliminated. IE. In my home town of Mt. Shasta(about 8000 population) SnowCrest, Inc. was the only Internet service available until a CLEC(Pac West) opened up the opportunity for other ISP's to enter the market, currently there are easily 10-20 different ISP's to choose from. Currently there are NO other ISP's physically based out of Mt. Shasta, therefore if Pac West were to fold due to the loss of reciprocal compensation and the subsequent abandonment of ISP's Mt. Shasta would again return to only one Internet Provider besides the ILEC.

IV. Conclusion

A. Reciprocal Compensation is not a handout but rather payment for the service and cost of terminating a call.

B. The presence of CLEC's has brought about large increase in competition in California which gives consumers greater choice, lower prices, and faster access to new technologies.

C. Congress should not eliminate or change reciprocal compensation in its present form unless they wish to risk severe change to the manner in which consumers access the Internet.

Mr. TAUZIN. Thank you very much.

The Chair recognizes himself for 5 minutes, and we will thereafter take that hour break as we go to vote. We will come back, and Mr. Markey will be first up.

Mr. Strickling, first of all, you issued—the FCC issued the order, declaring it interstate traffic. In February 1999 you said we had to have some regime in place while we were deciding what to do about it. It wasn't until February 2000 that the court finally ruled.

Why didn't you use the year between February 1999 and 2000 to settle this, if this is truly an interstate issue?

Mr. STRICKLING. Yes, sir. That is a good question.

Mr. TAUZIN. Let me preface it even better for you. We have seen you move fast when you want to move fast. Low-power television, e-rates all kinds of quick movement. When you want to do something, you can go there. You obviously didn't want to do there for a year. Why not?

Mr. STRICKLING. Well, Mr. Chairman, I don't think it was a question of not wanting to do it, but I think as this demonstrates today——

Mr. TAUZIN. Did you notice any notice inquiries during that year?

Mr. STRICKLING. Yes, sir, we did. At the time of our ruling, we issued a notice of proposed rulemaking. Parties filed a ream of comments in response to that. Extensions were granted to parties to file additional comments. Parties came in and peppered us with ex parte meetings all throughout the summer and fall; and then we organized to get going on that, and were working on it. We were nearly through with our work before the court of appeals then intervened with its decision earlier this year.

Mr. TAUZIN. What have you done since the court of appeals rule?

Mr. STRICKLING. As I indicated, the Commission is issuing a further notice in this matter in the next few days.

Mr. TAUZIN. So what happened in the 4 months?

Mr. STRICKLING. Well, sir, I would suggest to you the New York 271 happened, the Texas 271 has been before us.

Mr. TAUZIN. So you have been busy.

Let me just tell you again, when you want to move on things with all these other things, you move pretty fast. I appreciate your commitment to get it done by September. Let me just thank you for that; and I hope that you move as expeditiously on it as you move on other issues when you really want to do something.

I want to get quickly into the issues while I have time.

First of all, Mr. Kissinger and Mr. Taylor, are you aware of the meeting that occurred in Orlando, reported by Communications Daily on Thursday, May 25, called "ISP/CLEC Expo Conference"?

Mr. TAYLOR. Yes, I am.

Mr. TAUZIN. Are you aware of the report that came out of that meeting? I will read it to you.

One ISP leader complained that CLECs never shared much reciprocal compensation money, barely even offering her company the discounted phone rates when they clearly profited from every call. Another unapologetically talked of her annual battle to get her kickback if she became a CLEC herself. The conference session showed ISPs how to make the transition to CLEC status to ensure they reap the benefits.

You tell me you don't know of it going on. Here's a conference where people are being taught how do it. What is the truth here?

Mr. TAYLOR. Certainly there was a panel on ISPs becoming CLECs, and there are a lot of people selling sham business ideas.

Mr. TAUZIN. And there are kickbacks obviously.

Mr. TAYLOR. I am unaware of any kickback.

Mr. TAUZIN. I am making you aware of it. Communications Daily on the conference, here's a gal that says she had an annual battle to get her kickback. Apparently she has to fight every year to get it, but she gets it. She finally figured out she didn't have to fight for it if she became a CLEC. So it goes on.

Mr. TAYLOR. I think we had the example of the horses making calls into the Internet. There is always going to be a bad apple.

Mr. TAUZIN. Horses making calls kind of makes an example, makes the case for us to act.

Aside from the case of the shams and the conferences teaching people how to sham this system and how to get kickbacks, let's talk about the numbers, Mr. Kissinger. You and Mr. Tauke have a very different set of numbers. Mr. Tauke told us it is costing his company $60 million a month, doubling every 100 days. I will multiply that by 12; that is $720 million a year just to one company, just to one of the Bells—$720 million a year, not the $200 million.

Mr. KISSINGER. The numbers I quoted from were SBC's annual report. That is their numbers.

Mr. TAUZIN. That is for one company last year.

Mr. Tauke, your numbers are a current $60 million a month right now?

Mr. TAUKE. Yes. I am going to the first quarter of this year. I don't remember precisely what our numbers were last year, but our numbers last year were much less.

Mr. TAUZIN. This thing is accelerating into a problem, I think.

So the numbers you have, if they are dated, might not reflect how big they are today; is that fair?

Mr. KISSINGER. The current annual report that is available——

Mr. TAUZIN. I understand. But I am hearing testimony, and I have heard from other from ILECs the same kind of testimony, that the numbers are accelerating pretty rapidly right now.

Mr. KISSINGER. My point was, as those numbers are going up, there is a much larger explosion.

Mr. TAUZIN. Let's ask about that. Mr. Tauke pointed out in his charts, he collects certainly $15, a flat rate for a second line. But he may be paying out $18 or much more to the CLEC under this compensation arrangement. So then, while collecting for that second line, they are being charged a lot more; is that correct?

Mr. KISSINGER. I would say that is a contrived situation. What we need to do is look at the bottom line.

If you do, on their annual report, they will show they are generating billions of dollars in new revenues and they have——

Mr. TAUZIN. Mr. Tauke, respond quick.

Mr. TAUKE. The bottom line is that if they have $400-and-some million dollars in revenues, as he said, for second lines, and they are paying out $288 million in recip comp, they also have a lot of other costs associated with those second lines.

Mr. KISSINGER. That is not right.

Mr. TAUKE. But I don't know precisely what is in the SBC annual report. What I do know is, if you are on the Internet 2 hours a day, if the recip comp cost is greater than the cost for the second line—let me point out, too, if you look at the Web site, the Texas ISP Association puts up, they say many CLECs build business plans around being the low-cost providers of local exchange services to Internet service providers. And the cash-flow currently is from SWBT, that is, SBC, to the CLECs, millions of dollars each month, because a dial-up or SDN connection to the Internet is currently handled as a local exchange call terminating at the ISP.

So maybe there is no direct kickback, but they certainly point out that the way they are financing these lower costs is——

Mr. TAUZIN. Is through the payments.

You make in your testimony—I want to give you a chance to comment. We will have to go vote. You make in your testimony, Mr. Tauke, the argument that, look, we agreed in advance there wouldn't be access charges coming our way in this one-way traffic.

Mr. TAUKE. Correct.

Mr. TAUZIN. But now we are being charged the other way. What you are telling us, in effect, is, if you are going to continue to be charged in this direction, you either have to collect it from your customers—as Mr. Blossman pointed out, from your consumers, or you are going to be up here asking for some kind of access charge to balance the scale. Either way, somebody is going to get hit.

Mr. TAUKE. Somebody has got to pay when there isn't much money flowing. The money doesn't relate in any way to the costs.

Mr. TAUZIN. Mr. Blossman, you are an elected public commissioner. You have to answer to consumers on election day.

Mr. BLOSSMAN. Yes, sir.

Mr. TAUZIN. I take it your testimony is, you are deeply concerned that you are going to be asked, as in the case Mr. Tauke pointed out, for rate increases to cover this?

Mr. BLOSSMAN. If they are allowed to pay reciprocal compensation for this, the Bell companies are going to come to us and ask for us to raise their rates to help pay for it. And some consumers who will pay that aren't hooked onto Internet, and that is something I am trying to avoid.

Mr. TAUZIN. See, I like the—I think Ms. Smith kind of points us in the right direction. Here the consumer is being charged a flat rate by the local telephone company for access to the Internet, and we in Congress have very much—strongly opposed the charges.

But the ILEC is being charged per minute for, indeed, these same services. So they are being charged per minute, but then only charged a flat rate. There is something wrong with that system. I don't know what the total answer is yet, but we have got to correct it.

Mr. Taylor, Mr. Kissinger, I want to give you a last statement.

Mr. KISSINGER. Again, Bell Atlantic is distorting the issue. Southwestern Bell generated 488 additional revenues just from lines installed in homes—second telephone lines in.

Mr. TAUZIN. Let me ask you to do this. We will gather the latest and best information. Substantiate your numbers. Substantiate the best you can. We want to see them both.

The Chair will declare a recess for 1 hour. We will come back at 1:45. The committee stands in recess.

[Whereupon, at 12:45 p.m., the subcommittee recessed, to reconvene at 1:45 p.m. The same day.]

Mr. TAUZIN. The subcommittee will please come back to order.

The Chair is pleased to welcome and recognize my friend from Massachusetts, Mr. Markey, for a round of questions.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Mr. Tauke, let me clarify here, because I think we just have to understand, to be honest with you, the nature of this debate. Because if I could summarize what the Bell companies seem to be suggesting is that telecommunications carriers should operate under a regime of reciprocal compensation except that ISP-bound calls should be dealt with under bill and keep. Earlier, your chart suggested that zero compensation would exchange hands between carriers in the case of an ISP-bound call. Do you believe that the carriers who have ISPs as customers incur no costs for terminating traffic?

Mr. TAUKE. First, let me start this way. I want to clarify that this legislation and the position—that we are saying is not necessarily that there should be no compensation paid by a local exchange carrier to an another company if an Internet call goes to that company and is then sent to an ISP. We are saying that the reciprocal compensation scheme that was established for local voice traffic should not be the compensation mechanism.

Mr. MARKEY. Should?

Mr. TAUKE. Should not be the compensation mechanism. Or to put it another way, do not look at the cost of—for delivery of a voice call and apply that to the Internet traffic.

Now, in terms of costs, this is a real challenging issue. What is the cost? Because there are a lot of different circumstances. We cannot demonstrate but we believe that today over half of the ISPs in our district who are in our region who are served by competitive local carriers are co-located with the competitive local carrier. The competitive local carrier can require Bell Atlantic to deliver the traffic to them. If they are co-located then with that ISP, they have virtually no cost in transferring the traffic to the ISP.

Mr. MARKEY. Now just stop right there. Let me go over to Mr. Kissinger and Mr. Taylor. Virtually no cost. Can you comment on that?

Mr. TAYLOR. Yes. In the New York metropolitan area we connect with fiber, our switches, to over 300 Bell Atlantic end offices. There is a tremendous cost. And we pay Bell Atlantic a lot of money for that connectivity. We need to connect to all of those end offices because we need to improve our network to offer a better quality of service than the Bell Atlantic network. So we have cost in taking fiber to the 300 central offices that Bell Atlantic operates in the New York City-New Jersey metro area. Then there is the cost of the rent and the cost of the switching and the fiber in the ground and then, finally, the cost of electricity to run it. And half of our ISP customers are not co-located with it.

Mr. MARKEY. But, Mr. Tauke, you believe the ISP call composition should be cost-based, is that correct?

Mr. TAUKE. Yes. But let me point out that the compensation should be cost-based, taking into account two things. One is that you have to question whether or not the network that he is talking about is not a network that should—where the cost should be covered by the ISP. If we serve the ISP, we are paying for that network based on the recovery we get from the ISP.

The second observation I would make is that he acknowledged in their case half of their ISPs are co-located with them, which was the same figure that I gave you. But where there isn't that network cost——

Mr. MARKEY. I think this is a very interesting discussion, because it kind of gets us to this now kind of 25-year-old discussion of cost-based, you know, access. And it raises necessarily, you know, the issue of all local traffic in terms of whether or not access that is cost-based on the wireless traffic and all access charges whether or not they should be cost-based. Because I think that is a good discussion, actually, for the committee, I mean, philosophically, one way or the other, where should we be?

Because then we don't kind of tease out one part of it, but we look at it in this larger kind of long-term telecommunications philosophical perspective. And I think that is the question that we have. Should we look at the Tauzin bill and just add cost base for ISP traffic or should we broaden that out and add cost base for everything? And then we have kind of need a larger policy discussion that gets kind of at the core of the dispute that exists on both sides regardless of what is going to be done because they are going to be doing more and more as will our other competitors and will constantly see these disputes.

I guess the question I have is, should we have one set of rules and then we don't have to revisit them or should we have an ongoing revisitation of separate rulemaking, separate rules for each individual sector which causes us, you know, to be basely serving as a national PUC up here?

Mr. Strickling, then Mr. Tauke.

Mr. STRICKLING. I think you are raising an excellent point, but I would also urge you to go perhaps even the next step and consider whether, since one of the goals of the act is the eventual deregulation of this business, whether the end game regime we should be looking at is one in which there is no longer any requirement of compensation between carriers for any purpose. In other words, if you want to get into this business, you get into this business knowing that you must recover the costs of being in business from your customers.

This is an issue that would take years to implement on a regulatory—as a regulatory matter, but it is, I think, part of the debate that we ought to be moving to at this point. Now that we have completed a fairly comprehensive and massive access charge reform program, we have got some years here to take a look at what the end game really ought to be. I think we ought to be looking at that as an option.

Mr. TAUZIN. Without objection, the gentleman is yielded an additional 2 minutes.

Mr. MARKEY. I thank you.

Let me go to Mr. Tauke, then Mr. Taylor.

Mr. TAUKE. First, I think that what Mr. Strickling suggested is not a bad idea for the long term. But we do have to understand there are a lot of questions. For example, are we willing to bite the bullet on local service costs if we say that there are no intercarrier compensation charges? And this is just a tough issue. I think there are a lot of economic and market reasons why you might want to do that, but I also can acknowledge from your perspective that that is a tough one in terms of this particular issue of whether you wait until you see the whole picture of intercarrier.

Mr. MARKEY. In other words, should we go to bill and keep for everything and just jump-start this whole deregulation process? Should we just go for it and whatever happens, happens? You know, rather than trying to be seers, we just accept the marketplace. Then picking winners and losers based upon who is doing the better job?

Mr. TAUKE. I happened yesterday to be in Coeur d'Alene, Idaho. If you say to Coeur d'Alene, Idaho, listen, there is no intercarrier compensation, the end user pays the bill for the cost of that service, it is going to be kind of problematic for places in Idaho or Montana or Iowa—or even Massachusetts. So that is just the political issue.

But on this other question about do we wait until we see the whole picture, traditionally, that is not what we have done. When there was a problem about access charges being paid by Internet conditions to local exchange carriers, we acted to address Congress, the FCC acted to address that problem. Pay phone compensation, which Mr. Strickling alluded to earlier, there was an action to address that problem. This is a problem where I think there is a sense of urgency because of the amounts of money that are flowing and the distortions that are occurring.

Mr. MARKEY. I appreciate that. But there is huge amounts of money in these other areas as well, just vast amounts of money that are almost impossible to accurately determine access charges.

Mr. Taylor.

Mr. TAYLOR. I think when you look at it from a cost-base standard—and certainly the act that you all created that had that as the mandate and really asked the States and the FCC to enforce cost base, doesn't matter then what the dollar amount being paid by Bell Atlantic to CLECs is because that is also the cost they are avoiding. So at the end of the day, if we get to a rate that is cost based, everybody will be indifferent. There is no game left in the system. There is no ability for somebody to take advantage of the direction of traffic, and we have achieved the optimal point in the business game.

And the costs getting to those cost rates in the last 12 months—our rate with Bell Atlantic dropped 90 percent. I don't believe that Bell Atlantic has changed their business that remarkably in the last 12 months, that they have driven that much cost out of their business, but they simply said the rate will go down by 90 percent.

Mr. MARKEY. Mrs. Smith, I am glad that you were able to come back. The States are acting on this issue. They are making decisions. Some of the decisions are not to act, but they are making decisions.

How would you answer the charge that the PUCs are not responding to a very real marketplace anomaly, something that is out of whack with the real intent of the law, and that the Congress has to intervene in order to supercede the decisionmaking process which has been going on at the PUC level? How would you answer that in terms of what the PUCs have been doing?

Ms. SMITH. I would respond with utter surprise since this is an issue we really dealt with since the early 90's, ever since any other carrier entered the marketplace and we had to figure out how the relationship would go. And, of course, compensation is the No. 1 issue.

In Oregon, in the early 90's, we spent 2 years on this stuff. As Commissioner Blossman said, they have an open docket now. I think the States are basically dealing very creatively with it.

And if you look at Mr. Tauke's testimony, you will see references to Colorado, for example, and what they came up with. As things change, as technology changes, I see the States changing, but I still want to emphasize that, essentially, this is a contract between two business entities. And we really need to pay a vital role—play a vital role only when the two entities can't agree. But I would say across the board—and I would love to provide you with the information—that it is being handled.

Mr. MARKEY. Thank you, Mr. Chairman.

Mr. TAUZIN. The gentleman's time has expired.

The Chair recognizes the gentleman from Illinois, Mr. Shimkus.

Mr. SHIMKUS. Thank you, Mr. Chairman. Perfect timing, because I—Mr. Largent, in his opening statement, talked about the contracts coming up for renewal, which means negotiating between two parties. Why won't—I think if that is coming about, how would the proposal—let me say it another way. I think we ought to—will the ability of the two parties to renegotiate these contracts change this entire debate? And will the market forces cause there to be the change that some are proposing legislatively?

And I will just—let's go to, with all due respect, to Mr. Tauke. Then I will go to you Mr. Taylor.

Mr. TAUKE. This is at the heart of the problem, the way the negotiation process works.

An example is with our friends at Focal. We work for the Delaware Commission. We were unable to reach a negotiated agreement, a rate. So the Delaware—we went to fact finding. The Delaware Commission asked Focal as a company to produce information about costs. At that point, Focal said, no, we are withdrawing; and then they MFN'd another contract.

Our problem is that we can't as a—we do not have any leverage to be able to force the issue. Which is why this legislation puts—in a sense draws a line at the end of the current contracts to force a new negotiation. Because today somebody can take another agreement that is already in place, and as long as you have another agreement in place with the reciprocal compensation rate of three-tenths of a cent or four-tenths of a cent or six-tenths of a cent, a minimum, that becomes almost a floor in these negotiations. You don't have to have a negotiation. You can just take another agreement that is on the record in that State.

So these things just keep rolling, and that is the problem with the negotiating process. And, in essence, what this legislation does is stop the MFNing so you can give a negotiation on this issue.

Mr. SHIMKUS. What is MFNing? Can you——

Mr. TAUKE. I am sorry. It is like Most Favored Nation status. If we have an agreement——

Mr. SHIMKUS. We call it normal trade relations these days. I know you have been gone for awhile.

Mr. TAUKE. Sorry about that.

Mr. SHIMKUS. Mr. Taylor.

Mr. TAYLOR. Certainly in the specifics of Delaware we chose to opt into an agreement versus go through the cost of a cost study. But by no means did we get any length of increased term. We simply got the same term that the other agreement had.

So we as a company and as an organization are not in favor of sort of the perpetual daisy chaining of agreements. This was simply we opted into an agreement that had a shorter duration actually than if we had gone by ourselves and negotiated a new one.

But I think your question and the key point is, in every State we have negotiated an interconnection agreement, from our inception to today, the rates have gone done. And that is important because we as a business, we as a CLECs and the CLECs community need those rates to go down.

None of us wanted high rates as to begin with. As a number of members, including Mr. Largent, pointed out, we had all asked for bill and keep at the inception of competition. So we as an industry have been driving to cost-based rates since it was determined that the rates couldn't be zero a la bill and keep. And we think once we get to cost base—and we have seen it. There are certain Bell operating companies that aren't there yet, but hopefully, as Mr. Strickling pointed out, the incentives should be there for them to get to cost base quickly. Once they are there, the costs that they incur are the costs that they avoid, and they should be indifferent to the issue.

But I think in Illinois and California and Texas and New York, we have all seen rates drop dramatically, some 90 percent, these rates have gone down in a 12-month period, which means somewhere costs evaporated.

Mr. SHIMKUS. Let me follow up. The legislation proposed—obviously, would you take the opposite tack and say it would be detrimental to the reduction in the cost-base negotiation that you are saying is currently going on, is that correct?

Mr. TAYLOR. Our point is that the current contractual process between two business parties works. And if that doesn't work, the current arbitration process with the States and the various parties presenting information in front of a hearing and arbiter does work. And we have seen through both the contractual process and the State arbitration process the rates coming down and people agreeing to do this.

Mr. SHIMKUS. Thank you.

And now, if I could, I want to go to Ms. Smith. I know you are not from Delaware, but based upon the two comments from Bell Atlantic and an ISP provider, what works for you, the Public Utility Commission?

Ms. SMITH. I hope it is all right to answer in Oregon terms rather than Delaware terms.

Mr. SHIMKUS. I think the folks from Delaware would probably appreciate that.

Ms. SMITH. Since I don't know their background.

Mr. SHIMKUS. But you are part of the association. You probably know more about this negotiation and case than we would.

Mr. SMITH. It varies from State to State, the extent to which the commissions butt in. I use that term advisedly because in our State we are looking for as open a market as possible.

So in our arbitrations, for example, there are only two parties, the two negotiating parties. No other parties are allowed. So we don't get a whole bunch of folks in there stirring the batter, if you will.

The parties could choose their arbitrator. They could choose one of our administrative law judges or anybody else they want.

What we try to do is encourage those two parties to make the best deal they can with each other. And sometimes for transactional cost for one side or the other, both sides do it, will choose a piece of another contract for reasons such as Mr. Taylor described. But, by and large, again, I am having trouble, except for this one anomaly, understanding what the major problem is if the two parties are negotiating in good faith.

Mr. SHIMKUS. And, Mr. Chairman, if I could just follow up to Ms. Smith, will H.R. 4445 open the system, as is your desire in the State of Oregon as the Public Utility Commissioner, or it will hinder the opening of the system?

Ms. SMITH. Well, as I said in any testimony, there are two major concerns that we have. First of all, that the bill says specifically no compensation. That is not right. That will hinder competition, because it shifts the costs all around. And the second is it picks out one kind of service and regulates that service outside of the State regulation. And we think that the marketplace is more a whole than just carving out one piece, especially the Internet piece.

Mr. SHIMKUS. Thank you.

Mr. Chairman, I will yield back my time.

Mr. TAUZIN. The Chair now recognizes the gentleman from Michigan for a round of questions.

Mr. DINGELL. Thank you, Mr. Chairman. I appreciate your courtesy.

This question to Mr. Kissinger. Mr. Kissinger, I understand you say that the Bell companies are profiting greatly from the explosion of the Internet through second lines. However, I would like to raise a couple points. If I subscribe to Bell Atlantic and lease a second line for $20 per month and I use that line, as do many people, to dial up to my ISP for 24 hours a day, 7 days a week, then Bell Atlantic must pay the CLEC serving my ISP over $200 a month in reciprocal compensation, isn't that correct?

Mr. KISSINGER. I don't know what the rates are, sir, so I couldn't comment on whether that is.

Mr. DINGELL. That is about the average amount.

Mr. KISSINGER. Okay.

Mr. DINGELL. But you wouldn't deny that.

Mr. KISSINGER. I don't have any basis to deny.

Mr. DINGELL. That works out to a net loss for Bell Atlantic of about $180 a month—every month. Now, how is this money to be made up? Bell Atlantic has lost $180 a month. How do they get it back?

Mr. KISSINGER. If I may, I think that that example is somewhat contrived. And if I could——

Mr. DINGELL. Let's hear from Mr. Tauke. Mr. Tauke, is that contrived?

Mr. TAUKE. Well, right now, the average is about half a cent a minute. If you are on 24 hours a day, I think that is what it amounts to. So there are people who do this.

Mr. DINGELL. Do you disagree, Mr. Strickling?

Mr. STRICKLING. No, sir.

Mr. DINGELL. How about you, Ms. Smith? Do you disagree?

Ms. SMITH. I am sorry, sir. I was distracted because of further appointments.

Mr. DINGELL. I would hate to bother you while you are distracted. I guess we will have to go on with another question.

Now, you are testifying, Mr. Kissinger, in support of this practice, is that right?

Mr. KISSINGER. In support of which practice?

Mr. DINGELL. The one described by Mr. Strickling and Mr. Tauke.

Mr. KISSINGER. I am saying that practice doesn't exist in the marketplace.

Mr. DINGELL. Why do you say that?

Mr. KISSINGER. What I am saying is that my experience has shown that 30 to 40 percent of my users that sign up never called in a month. They sign up for Internet service, and they buy a telephone line, and they are excited about the Internet——

Mr. DINGELL. Would you deny that what I have said is factual?

Mr. KISSINGER. I am not saying it is not—that that situation would actually happen.

Mr. DINGELL. So you agree that it is factual.

Let's go then to the next question. Mr. Kissinger, do you receive heavily discounted service?

Mr. KISSINGER. No, sir.

Mr. DINGELL. Do you receive other special payments or benefits from the CLEC to which your ISP subscribes?

Mr. KISSINGER. Absolutely not. My telephone service is 3 percent lower than that, that I get under tariffed basis, than Southwestern Bell. I receive no other compensation.

Mr. DINGELL. No other compensation whatsoever.

Mr. KISSINGER. None.

Mr. DINGELL. Does anybody else in the industry receive compensation of a special character?

Mr. KISSINGER. Competitors within industries typically don't talk about their contracts with partners.

Mr. DINGELL. It strikes me that you should probably renegotiate your deal with your CLECs.

Thank you very much.

Now, Mr. Strickling, are you aware of a company called Navipath?

Mr. STRICKLING. I am sorry, what is the name again?

Mr. DINGELL. Are you aware of a company called Navipath?

Mr. STRICKLING. No, I am not, sir.

Mr. DINGELL. Are you, Ms. Smith?

Let's just talk about this then. It has been widely reported that there has been a terrific new technology that they provide the CLECs. The technology permits Internet-bound calls to bypass the CLEC switch entirely. Are you either you or Ms. Smith aware of this?

Mr. STRICKLING. Yes, I am.

Mr. DINGELL. You are.

Ms. SMITH. No.

Mr. DINGELL. Is this possible?

Mr. STRICKLING. I think technically it is.

Mr. DINGELL. Is it going on?

Mr. STRICKLING. I don't know.

Mr. DINGELL. You would anticipate if it is possible it probably would start if there is an economic advantage, would you not?

Mr. STRICKLING. Absolutely, sir.

Mr. DINGELL. I would note that Navipath requires the CLECs to share the reciprocal compensation windfalls siphoned from the Bell companies in exchange for using this technology. Would that surprise you?

Mr. STRICKLING. No, sir.

Mr. DINGELL. Now, in your view, is this legal or proper? Oh, I would note that it results in zero cost to the CLEC for terminating that traffic.

Mr. TAUZIN. Mr. Dingell, would you yield for a second? I think we have got a poster that demonstrates exactly that situation.

Mr. DINGELL. I am not familiar with it, so I would be happy to continue yielding to you, Mr. Chairman, for purposes of enlightening us all.

Mr. TAUZIN. I ask the witnesses who are answering Mr. Dingell's question to examine the poster here which illustrates exactly that situation, where the traffic goes directly to the ISP under this technology, and there is no—it simply bypasses the CLECs completely, as you can see in the demonstration here. Is this, Mr. Strickling, what Mr. Dingell is referring to, this sort of situation?

Mr. STRICKLING. I really can't see the chart to tell—but I think we can go along and let's assume it is.

Mr. DINGELL. Let's now get to the point here. If this is going to result in no cost to the CLECs, why should the CLEC be in there to get paid by any of the providers?

Mr. STRICKLING. Again, our Commission hasn't spoken to this topic yet, but let me give you my own personal view.

Mr. DINGELL. You are a very intelligent fellow. You are here as an expert to guide the committee. And I want to you know I am impressed with your qualifications. And this impression that I have of talents and ability down there compels me to ask this question.

Mr. STRICKLING. Fine. I will try to answer to the best of my personal ability.

First off, the act is based on the notion that parties are going to negotiate contracts with each other.

Mr. DINGELL. But is it negotiated—is it passed on the thesis that they are going to be getting something for doing nothing?

Mr. STRICKLING. You would expect and hope that that would be a matter handled in negotiations. My personal view is if a regulator intervened in that situation you would not allow compensation on——

Mr. TAUZIN. Would the gentleman yield for a second?

Mr. DINGELL. I am happy to yield, because I am struggling with this.

Mr. TAUZIN. Mr. Tauke indicated to us I think—what is the correct phrase in this enterprise—the notion of the Most Favored Nation contract. If this fake CLEC comes along and has this technology to bypass a CLECs so the compensation flows directly to the ISP that has shell-gamed the situation, if it applies for a contract reciprocal compensation with Bell Atlantic and they can't come to a negotiated term, it is entitled to the best Most Favored Nation's contract, right?

Mr. STRICKLING. That is the way the law was written.

Mr. TAUZIN. So it gets paid for doing nothing, doesn't it?

Mr. DINGELL. Is that law or is that FCC ruling?

Mr. STRICKLING. No, sir, that is in the law.

Mr. DINGELL. So you are forcing me to believe that to change this unfortunate situation that Congress has to pass a law, am I right?

Mr. STRICKLING. I don't think so, sir. I think that you are seeing that the market is changing to adapt to this today.

Mr. DINGELL. It hasn't shown me any signs of change today.

Mr. STRICKLING. I think Mr. Taylor mentioned—and we can give you other examples. Bell Atlantic has negotiated with Level 3 rates only 10 percent of what they were charging.

Mr. DINGELL. I would hate to wake up the FCC to have them look at a problem of this kind, because they have been resting so comfortably beside it for so long that I am not sure that they wouldn't wake up in a bad state of mind and that might be a shock to their systems. So I am not really anxious to do that.

Let me ask Ms. Smith. Ms. Smith, these arrangements under current practice are arbitrated by the States, are they not?

Ms. SMITH. I think so.

Mr. DINGELL. If there is no agreement, the State arbitrates them. And the State says now to poor Mr. Tauke, who is sitting there between you looking very sad, you say, Mr. Tauke, you have got to pay Navipath or somebody else, perhaps one of the other panel members, so much money a month. And now this new technology comes along, and they don't have to do anything, and they still get paid. I am curious, do the States endorse this and does the FCC endorse this practice?

Ms. SMITH. First of all——

Mr. DINGELL. It is a very simple question. You have arbitrated this thing. They have to pay. There is zero cost to the CLECs for terminating the traffic, and they still get paid.

Ms. SMITH. We wouldn't arbitrate it because they wouldn't be certified as a competitive local exchange carrier, and they couldn't get certified as a competitive local exchange carrier unless——

Mr. DINGELL. With all respect, Ms. Smith, this is a wonderful answer. I do want to hear it in good time. But the question was, really, do you endorse this practice?

Ms. SMITH. No.

Mr. DINGELL. Do you think this is fair and good in the overall public interest?

Ms. SMITH. As I said in my testimony, I do not.

Mr. DINGELL. You do not.

How about you, Mr. Strickling? Do you endorse this practice and think this is good and sound?

Mr. STRICKLING. If you are referring to opting into agreements, it is in the law.

Mr. DINGELL. I am asking whether getting paid for doing something is something that the Federal and State law enforcers should insist upon, because that is the current system it seems.

Mr. STRICKLING. Sir, it is the law today. I don't think I could change it if I wanted to.

Mr. DINGELL. But you told me that this would all work out in testimony just a little bit back now. My heart suddenly leaped with hope.

Mr. STRICKLING. It is working out because contracts are 3-year terms, generally. They can't be extended beyond the term they were originally negotiated for. So the threat that Mr. Tauke is worried about is a very limited, short duration.

Mr. DINGELL. Let's talk about poor Mr. Levin, who is standing here next to me. He is a great believer in the Internet, and he subscribes. He is paying all this money into Bell Atlantic, and Bell Atlantic is getting screwed by having to pay money to somebody who is doing nothing, and it actually is resulting in a situation where they are functioning at a loss. And now poor Mr. Levin is now going to have to pony up in his monthly telephone bills because neither you nor Ms. Smith is doing anything to see to it that somebody doesn't get paid for doing nothing.

Mr. TAUZIN. Give that man a raise, Mr. Dingell.

Mr. DINGELL. I want you and Mrs. Smith to tell me how fair this is or, in the alternative, tell me you think this is profoundly unfair. Which view do you have?

Ms. SMITH. I think it is profoundly unfair.

Mr. DINGELL. How about you, Mr. Strickling? We have here some expert advice. I am waiting to hear what you have to say.

Mr. STRICKLING. I don't know that it is profoundly unfair or not. The question that is being begged here is, why does Mr. Levin get to stay on the Internet 24 hours a day, 7 days a week, and pay $15 a month for phone service?

Mr. DINGELL. Because he has a contractual arrangement with Mr. Tauke. Are you telling me that Mr. Levin ought not to be able to negotiate a contractual relationship with Mr. Tauke whereunder he could use the Internet for 24 hours a day? Certainly the FCC has not become so totally authoritarian as to——

Mr. STRICKLING. Certainly he should be able to negotiate.

Mr. DINGELL. Now come back and tell me again. Do you think this is fair or unfair?

Mr. STRICKLING. I think it is an isolated example from which one could not draw a general conclusion.

Mr. DINGELL. Am I interpreting that as meaning that you and the FCC don't care a lick about this matter?

Mr. STRICKLING. Not at all, sir.

Mr. DINGELL. But your diligence in addressing this matter seems to be rather small.

Now, Ms. Smith, we have a few good questions for you. The State commissions are responsible for certifying companies as CLECs, are they not?

Ms. SMITH. Yes.

Mr. DINGELL. Let me read to you and the rest of the panel—I think you will all enjoy this—a press report from Communications Daily on May 25, and I am now quoting: At a joint ISP-CLEC expo in Orlando last month, one ISP leader complained that the CLECs never shared much reciprocal compensation money, barely even offering her company discounted phone rates when they clearly profited from every call. Another unapologetically talked of her annual battle to get her—and I quote, "kickback," until she came a CLEC herself.

The article continues to say, the conference held seminars to show ISPs how to obtain CLEC status themselves to ensure that they could reap the reciprocal compensation benefits.

Now what are the States doing to combat this scheme where ISPs become CLECs solely for the purpose of compensation windfall and who has no intention of actually competing in the local telephone market? Here you got an entity which is being set up for the sole purpose, according to one of the insiders, of collecting money from poor Mr. Tauke who is sitting there and still looking sad.

Ms. SMITH. As I said in my testimony, let me give you the example of New York——

Mr. DINGELL. Pardon?

Ms. SMITH. Let me give you the example of the New York Public Service Commission which, when it discovered this issue, this anomaly, as it developed, sorted out the kinds of entities that you are concerned about, said, look, you don't get anything. You have to be somebody who is going to be facilities based.

Mr. DINGELL. I am hearing in your remark the kind of sense of outrage that I would expect from somebody from Oregon. I gather that you find this a displeasing situation, is that right?

Ms. SMITH. Absolutely.

Mr. DINGELL. Good. Pray continue.

Ms. SMITH. Any way they work out a scheme by which they take the reciprocal compensation and assure that the CLECs—if I have got this wrong, let me know, because I have just learned it last night—and assure that that money is put into infrastructure. If a company is doing as you described or as that poster describes, they don't get any.

Mr. DINGELL. Am I hearing you telling me that you don't like them stealing, but you don't mind them stealing if they put it in infrastructure?

Ms. SMITH. I am just, sir, telling you what New York decided to do. As I said in my testimony, I think——

Mr. DINGELL. Is my interpretation correct? I am just a poor Polish lawyer from Detroit, and I sometimes have a hard time dealing with these difficult technical questions.

Ms. SMITH. No, sir, your interpretation is not correct.

Mr. DINGELL. You object to them being paid for nothing, but you don't object to them being paid for doing nothing if they put the ill-gotten gains into infrastructure construction.

Ms. SMITH. Sir I am just saying what New York's solution was.

Mr. TAUZIN. The Chair would suggest to the gentleman—I am going to have to ask Mr. Shimkus to take the Chair, if he can do that, and I will be happy to make time available.

Mr. DINGELL. I will be happy to yield to the gentleman again. Because your questions are so much better than mine.

Mr. TAUZIN. Let me suggest that I am going to put Mr. Shimkus in the Chair, and he will make a time available to the gentleman from Michigan again. I want to make sure that the gentleman from Oklahoma has a chance.

I wanted to make one statement before I had to leave. The speaker is calling me to his office.

Mr. DINGELL. You have been so gracious that I will limit myself to one more question, if you would permit to ask that.

Mr. TAUZIN. Proceed.

Mr. DINGELL. Ms. Smith, would you tell us what is NARUC doing to eliminate this scam on the rest of the States and what is the FCC doing, other than sitting comfortably beside it?

Ms. SMITH. NARUC is educating its members on the issues, surveying which States actually have these problems, because I can't identify it for Oregon, and looking at solutions so that we can speak out authoritatively before Congress on what we believe the issues to be. But we can also solve them at our State level, if it takes State legislation to make sure if the act intended that facilities-based carriers that are getting the compensation that is what we are doing.

Mr. DINGELL. I gather you are telling me that you consider this strange new breed of combined ISP CLECs to not be true competitors in the local telephone market and in grave need of some additional attention, am I correct?

Ms. SMITH. Yes.

Mr. DINGELL. I hope that the FCC was listening with all proper diligence to that and that my colleagues on the committee were doing the same thing.

Mr. Chairman, I thank you.

Mr. TAUZIN. Thank you, Mr. Dingell.

I am going to put Mr. Shimkus in the Chair. Then he can round out the hearing. But ordinarily I like to make a few comments at the end. I won't have the chance since the Speaker has asked me to join him in his office right now. Let me, however, take a moment, with the consent of my friend from Oklahoma, to make a couple of comments. Then we will recognize him.

The first is that it seems to me one of the big problems we have in this whole equation of determining how to resolve these issues is that, on the one hand, coverage; and the FCC has set a policy in place that says we don't want people who use the Internet for data services to pay on a permit basis—or even passing a bill to codify that rule. At the same time, the phone companies whose lines are used to connect to the ISPs are being charged on a per minimum basis under this system. So that they are charging a flat rate to their customers and yet being charged on a permanent basis to support connecting up to an ISP.

And by the way, Mr. Kissinger, one of the CEOs of one of the large Bell companies last year told me about his own daughter, having to sell her a second line for which he is collecting $20 and it is costing him $200 a month. So it is not an unreal situation. Apparently, it occurs.

The bottom line is that we have a situation where, because Congress wants to keep data Internet service as cheap as possible, be available to people as this new economy develops, we are dead set against charging customers on a per minute basis, but the companies are charging each other on a per minute basis here. So it rattles. It somehow perhaps creates some of these anomalies we are talking about.

The second thing that I wanted to make a mention of and ask you all to think about is that, as we move from regular dial-up voice communications in America to IP telephony, there is going to be more and more discussion about should there be access charges, the charges that the telephone companies do not collect for data services. Should there be access charges in order to continue support for universal service? And we will be debating that at some point. Are there going to be permanent charges to use the Internet to make telephone calls?

And that whole issue of access charges and regulations on prices and terms and conditions is invading the whole Internet economy, will be before this Congress again, something this member, as chairman of the committee, is desperately opposed to.

And it concerns me that the longer we debate, all of you, the CLECs, the Internet providers and the companies that are providing the conduits, the longer we debate and continue this whole process of regulating who pays whom for what in a government forum, be it a public utility forum or FCC or Congress, the longer that pertains, the more likely it is that at some point all these regulations and subsidies are going to invade the new economy marketplace on the Internet, and that concerns me deeply.

So as a last comment I would ask you all to give some real serious thought to what we have learned today. I would certainly urge the Commission to have that sense of outrage Mr. Dingell was asking you to have about these abuses but also to speed up your consideration of how we might provide a better system for the time being until we have a fully competitive marketplaces where customers ought to make those decision before it is too late, before we see this marketplace move so rapidly into IP telephony where voice is almost given away in a package of services and all of a sudden we have demand for access fees and regulations to support universal service to close the digital divide. Who knows what else? I hope you are all thinking about that.

Help us, I am asking you. I am on my knees asking you to give us your best thoughts on how to resolve this as quickly as possible—hopefully without the need for us to pass bills in the area.

The Chair will pass Mr. Shimkus in the Chair and will yield to Mr. Largent for questions.

Mr. LARGENT. I want to get some perspective on this issue that I am supposed to be outraged about. When we talk about the local loop, what percent of the local loop is controlled by CLECs?

Mr. STRICKLING. In terms of how much local loop do they own themselves?

Mr. LARGENT. That is correct.

Mr. STRICKLING. We don't have perfect numbers on that, but it is certainly under 10 percent and probably under 5 percent.

Mr. LARGENT. The number I have is 4 percent. So the outrage that we are talking about here is why 4 percent of the people that control the local loop are being portrayed as monsters and abusing the people who control 96 percent of the local, am I understanding this correctly?

Mr. STRICKLING. That is certainly one way to look at it.

Mr. LARGENT. That really is outrageous, isn't it? How did you come up with—what I am trying to understand here—and I think it was Mr. Kissinger, maybe Mr. Taylor, who asked the question—the FCC made a determination that these sorts of phone calls were interstate. How did that come about?

Mr. STRICKLING. It was pursuant to a question that we make a declaratory ruling on this. And we took a look at the traffic and evaluated the fact that, even if it originates in one jurisdiction and then by going onto the Internet could travel to another State, could travel to another country—and indeed it seemed that the dominant nature of the traffic was it did cross State boundaries. And then looking at the analysis of where the call began and where that customer was and who he was communicating with, we concluded it was an interstate call. But that doesn't answer the compensation question.

Mr. LARGENT. This to me is a real fundamental issue that we need talk about in this hearing for this reason. It is my understanding—and I know I have this correct—that Bell companies cannot engage in long distance phone calls which are interstate. How can they engage in these phone calls that the FCC has determined are interstate?

Mr. STRICKLING. They are not allowed to transport traffic across the LATA boundaries, the inter exchange boundaries. It is probably better put to Mr. Tauke, but my understanding is the Bell companies, even with their Internet service provider, do not engage in the transport of that traffic themselves across LATA boundaries. They engage companies called global service providers to actually carry the traffic across the inter LATA boundaries.

Mr. LARGENT. Is it interstate or intrastate? You can't have it both ways. You can't say, on one hand, it is not really going across the LATA boundaries and so it is not really a long distance call but it is interstate transmission.

Mr. STRICKLING. I think the confusion there is that you have multiple companies involved in that transmission of one end user. And that the portion of the call handled by the Bell company is not itself crossing LATA boundaries, but then when you look for the transmission from end to end, from—in the example we are now talking about may involve a minimum of three providers even before you get to the Internet backbone provider who can be a fourth and presumably fifth, sixth and seventh provider, depending on where the call actually went. If you look at it end to end, those seven different providers all combine to offer an interstate transmission.

Mr. LARGENT. But what I am saying, because of the confusion and the ambiguity on this particular issue, it really allows a Bell company to come and sit at this table and argue any variety of issues on either side, whichever one benefits them. You understand what I am saying?

Mr. STRICKLING. Um-hmm.

Mr. LARGENT. And that makes it more confusing for members who are sitting on this side of the desk as a result of that.

Mr. STRICKLING. If I could just speak to that. A perfect example of that was raised by the chairman's last comment about how what we are dealing with is a combination of end user rates and per minute rates for this reciprocal compensation. That wasn't dictated by a regulatory scheme as much as it was by the negotiations of the parties back in 1996. At that time, the Bell companies wanted high per minute compensation rates. That is what we are living with now. And as we end this round of new negotiations we are seeing different structures result because the incentives have now changed. There is no longer a desire on the part of the Bell companies to have high permanent rates for this as compensation, and we are now seeing much lower rates and different kinds of rates as a result. I think that is good.

Mr. LARGENT. Mr. Tauke, is there a cost associated with terminating a call? I mean, beyond this new system that apparently came up. I am talking about the traditional sense. Is there a cost associated with terminating a call that is going to an ISP?

Mr. TAUKE. Yes. The problem that we have is that there is no mechanism that is being used to assess what that cost is. And, instead, the cost of terminating a voice call is used as a proxy for the termination of an ISP call, and the costs that are looked at are the costs of a Bell company, in this case, in terminating a voice call which includes loops to Aunt Tillie's house, if you will, at no the cost for an ISP. And if we have half of the ISPs, for example, where they don't have switching, they are collocated with the CLECs, the cost is very minimal.

Mr. LARGENT. But my question specifically is, is there a cost associated with terminating a call to an ISP? Yes or no.

Mr. TAUKE. Yes, there undoubtedly is some cost.

Mr. LARGENT. Then my next question is, H.R. 4445 says that it will be zero compensation, right? Is that fair?

Mr. TAUKE. I don't think that is what H.R. 45445 says. H.R. 4445 says there won't be reciprocal compensation.

Mr. LARGENT. That is what I am saying. There won't be reciprocal compensation.

Mr. TAUKE. But reciprocal compensation is the compensation rate determined for local traffic. It doesn't say there can't be some other form of compensation.

Mr. LARGENT. Let's talk about this issue. What I am asking you is, you have said that there is some cost, and I think we would all agree across this whole deal that it is probably not a cent a minute, it is something less than that. That is what the negotiations and the contracts that have been signed recently reflect. There is a cost associated with that. And yet we are eliminating reciprocal compensation on these types of calls. We are eliminating that. It is zero. My question to you is, is that fair?

Mr. TAUKE. Yes.

Mr. LARGENT. That is fair?

Mr. TAUKE. I will tell you why it is fair. Because, first of all, if you have a cost it doesn't necessarily have to be paid by the carrier who is sending the call. The people who are receiving the call are charging their end user, the ISP, for some service; and part of that service is for receiving the call. So they are covering their costs from their customer, not from the carrier who is receiving the call.

So then have you to determine whether that cost for terminating the call is so great that you should also receive some subsidy from the carrier sending the call. It is as we have talked about today. There a variety of mechanisms for compensating for costs. In some cases, it comes from another carrier. In some cases, it comes from end user. And the question is, what is the rate methodology for reimbursing the cost? And our contention is that the reciprocal compensation methodology, which was established for local traffic, not interstate, which was established for voice, not Internet traffic, is the wrong model for this determination of costs.

Mr. LARGENT. But it seems to me—I mean, I bet if we had another panel and we were talking about access charges for long distance, that we might hear you argue the other side of this debate. I mean, you might be on the other side of the fence when we start talking about access charges on long distance service.

Mr. TAUKE. It could be. It would depend on where the cost is.

But let me just say, as I said to Congressman Strickling—some days I think he is a Senator. As Mr. Strickling alluded to earlier, the fact is that you can make a strong argument there should be no intercarrier compensation. But then, when you go back to Oklahoma, you will have to say to your end users that they are going to pick up the total cost for the telephone service that they have.

That has never been a politically viable solution, and that is why we have various forms of intercarrier compensation. Because many end users, particularly residential end users, we assume, should not pick up the total cost of the services provided to them.

Mr. LARGENT. And that is exactly—brings us right back full circle to reciprocal compensation, which is essentially an intercarrier way of compensation. Just as you mentioned, we have that. And so what you are saying is, when it doesn't benefit you, we shouldn't have it. But when it benefits you, we should have it. Essentially, that is what you are saying. I mean, not even essentially, that is what you are saying.

Mr. TAUKE. I might be saying that, but I think——

Mr. LARGENT. That is what you get paid to say. You are supposed to say.

Mr. TAUKE. I do believe that you would recognize that that is an unfair characterization. What we are talking about is, does the method of compensation, A, make any economic sense; and, B, does the method of compensation result in bad—have bad results? And the bad results are that you are providing a lot of money that may be totally unrelated to the cost; B, that this could result in unintended consequences such as Internet usage charges; and, C, that you are making it very unattractive for competitors to go after the residential customer who is using the line for Internet access.

Mr. LARGENT. Let me just argue those points with you, but—not argue, but say, No. 1, I agree with you on A. Because I think everybody—as I said, that this should be a cost-based determining factor. I mean, the cost base should be what determines. And I think the negotiations that are occurring between the two parties that Ms. Smith talked about, those are happening.

Second of all, Congress has acted on the access charge and the per minute charge on the Internet. We said we are not going to do that. We are not going to go there. So we have addressed that legislatively.

And your third—what was your third point?

Mr. TAUKE. With all due respect, you haven't addressed the second issue. You said there will be no access charges, but you are doing nothing to prevent Roseville telephone, as I alluded to earlier, in California, from saying to the California Commission, we have got all these costs. Now we have got to recover them. We are recommending that you allow us to have a permanent charge for second lines so that I can recover that way.

And the California Commission can tell Roseville, yeah, we will allow to you have a permanent charge on second lines, which then means you have—that customer is paying an access charge to the Internet. Or they can say to Roseville, we won't let you do that, but we will allow you to raise your basic line costs a certain percent so that Aunt Tillie, who never goes on the Internet, gets to help pay for it.

There are a variety of ways that they could decide it, but the costs are very real for Roseville telephone; and somewhere along the line those costs are going to be recovered from an end user.

Mr. LARGENT. Has Bell Atlantic renegotiated any reciprocal compensation?

Mr. TAUKE. We are renegotiating all the time.

Mr. LARGENT. What has happened with the rates with negotiations with the CLECs?

Mr. TAUKE. They are essentially going down.

Mr. LARGENT. Substantially?

Mr. TAUKE. A number of them have gone done substantially. Some of them have not.

Mr. LARGENT. Have you been involved in renegotiating contracts with cell phone providers on reciprocal compensation?

Mr. TAUKE. Yes.

Mr. LARGENT. What happens to those rates?

Mr. TAUKE. Some of those rates are coming down as well.

Mr. LARGENT. As substantially as the ones related to the ISPs?

Mr. TAUKE. I don't think that the—I don't know that I can tell you what the rates are between—the difference in the rates between the wireless and the wire line, because they are treated differently in different negotiations. And the costs are totally different between wireless and wire line—comparing apples and oranges.

Mr. LARGENT. When you negotiate with a wireless provider you look at the cost as well.

Mr. TAUKE. Yes.

Mr. LARGENT. It is cost-based negotiations, right? Why shouldn't these be cost based? Why shouldn't we have cost-based rates when have you a reciprocal compensation agreement with an ISP?

Mr. TAUKE. They should be. But there are two factors—one is the MFN issue, which we talked about. The other factor is the determination of cost is made under the rules in this way in most States. They look at, first, the RBOC cost, not the CLECs costs; and they look at voice calls, not the cost of delivering traffic to an ISP.

Mr. LARGENT. Isn't that that a matter that the FCC could address?

Mr. TAUKE. The FCC could do a lot of things, but they haven't done it.

Mr. STRICKLING. What Mr. Tauke says is correct, but those relate to contracts negotiated in 1996. But no one had focused on these differences between handling traffic destined for Internet service providers as compared to voice traffic.

The States are very competent in this regard. When these issues come back before them in arbitrations, they know the field has shifted. They know that they will perhaps need to look at costs on this different bases and focus on the costs unique to Internet service providers. So I think it is way premature to be suggesting that whatever, however it was done 3 years ago we are going to repeat that in the States as these contracts come back through for arbitration this year and next.

Mr. LARGENT. I thank the chairman for giving me a little more time. I see it is not a very busy panel. But I just want to ask if Mr. Taylor and Mr. Kissinger had any comments, because I know you didn't get a chance to participate in the questions with Mr. Dingell.

Mr. TAYLOR. And I am deeply disappointed that I didn't have that opportunity.

I think when you look at the types of phone traffic as you were describing the way Bell Atlantic provides Internet access, we do the same thing that a Bell company does. We provide switching, we provide line, we provide phone numbers.

The thing, though, that is important to understand is, while the characteristics of usage of the Internet might be different than a voice phone call, from a telephone company perspective we don't see anything that is different. It looks and operates and smells exactly like a voice phone call or a fax phone call or, quite frankly, a cellular phone call.

We have many Bell operating companies that buy phone lines from us for their cellular units because we are a better provider of lines than the other competitive Bell company. We have big, large, soon-to-be Bell operating companies after their mergers that their Internet units buy phone lines from us because they are better.

And I think the key point is we do have a cost. You know, there has been $30 billion of costs that have been put in the ground by CLECs building for broad band infrastructure, bringing phone lines to homes and residential customers as well as big businesses in the Federal Government; and that $30 billion needs to be recovered through some mechanism.

And whether it is as Mr. Tauke describes some small phone company that is the exception in California having to raise its rates for—maybe they have never raised their rates in the last 50 years. I mean, it is difficult to say why they are raising their rates. Or the other extreme is to tell everybody that their AOL bill is going from $20 a month to $27 a month.

I think the key point is there is a cost. We as Focal and as a CLECs organization always believe that we should really focus on finding what that cost is. Because when it is a true cost it is simply—and every Bell company will be indifferent to paying that cost because it is a cost that they will be avoiding in the process. So I think you have, you know, really uncovered this issue very well and have gotten to the heart of this. Let's get to the cost.

Mr. LARGENT. Mr. Kissinger.

Mr. KISSINGER. Real quickly, about the free bypass on the switch, that is not a new technology. I bought that 3 years ago from Southwestern Bell. It was Internet throughway. It was a tariff service. When they had that tariff, they had to prove up their costs to get that tariff. It wasn't free. And I don't have access to those costs, but somebody does. And you might want to find out what they said it cost to provide that bypass of the switch for an Internet service.

Mr. TAYLOR. If I could, add Bell Atlantic does the same thing in New York.

Mr. KISSINGER. It is not new. It is available to them.

I think the fundamental thing—the two things that I think are real telling, is, No. 1, and I brought in the substantial issue, my claim that they are making so much money from Southwestern Bell's annual report and they are making a ton of money on this and they are not investing any of that money to service Internet service providers. They aren't showing up at our door to try to provide us service. When we call them, they put up all sorts of obstructions for us to buy service from them.

Thank you for the 1996 Telecom Act. It is working. We exist and the Internet today exists in the manner and the fashion that we see it specifically because we have competitive telephone service and because ISPs can buy competitive telephone service. If you remove the incentive for these people to do business with us, we are going to be left to the wolves, the ILECs who are our competitors. I would encourage you to be careful about doing that. This is going to have a dramatic effect on us.

Mr. LARGENT. Thank you, Mr. Chairman. I yield back.

Mr. SHIMKUS [presiding]. The gentleman yields back his time. And we are going to close, although I was informed by the minority staff, Mr. Taylor, that the ranking member did have questions for you; and you are probably the first one that would have liked to engage Chairman Dingell again. They did notify me that we could get him down here if you would like.

Mr. TAYLOR. Oh, that is okay.

Mr. SHIMKUS. Smart man. Quick learner.

This has been a great—obviously, a great hearing and one of the reasons why many of many of us love this committee, because we have to wrestle with this issue. There are a lot of issues.

My last shot across the bow is, I didn't ask questions—I am not going to—just for some of us in rural America have small telephone companies. I think of Grafton Telephone, which probably has about 350 households; Home Telephone Company in St. Jacob, Illinois, which probably has about 650; how will they be helped or hurt through this process. There are some costs.

But I think the point is being made the structure today may not work, but we do know there are some costs and how do we get to an amicable compensation and not just compensation for the cost but compensation for the investment and the return on the investment. And most of us understand that that has to be there for the country to grow and the services to be provided, but we want to make sure, just as universal service charges on our telephone bills, that all America has access to not only telephony but also data services through the Internet.

With that, I will adjourn the meeting. Thank you for attending.

[Whereupon, at 3:05 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[Additional material submitted for the record follows:]

Written Statement of

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before the

Subcommittee on Telecommunications, Trade and Consumer Protection

United States House of Representatives

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DESTROYING THE BALANCE: HR 4445

BACKGROUND ON RECIPROCAL COMPENSATION

Introduction

My name is Lee L. Selwyn. I am President of Economics and Technology, Inc. ("ETI"), One Washington Mall, Boston, Massachusetts 02108. ETI is a research and consulting organization specializing in telecommunications regulation and public policy. I have previously testified before the House Telecommunications Subcommittee on several occasions; a complete statement of my qualifications is attached hereto. I appreciate the opportunity to submit this written statement.

Titled the "Reciprocal Compensation Adjustment Act of 2000," HR. 4445 is a bill "[t]o exempt from reciprocal compensation requirements telecommunications traffic to the Internet." If enacted, incumbent local telephone companies would no longer be required to compensate connecting competitive local exchange telecommunications carriers ("CLECs") for traffic handed-off to them by the incumbent where the CLEC's customer is an Internet Service Provider ("ISP"). Specifically, Section 3(A) of the proposed legislation provides for outright exemption from existing reciprocal compensation requirements (except for interconnection agreements currently in force): "Notwithstanding subsection (b)(5), after the date of enactment of this paragraph, no local exchange carrier shall be required to make any payment for the transport or termination of telecommunications to the Internet or any provider of Internet access service." Section (3)(B) confers sole jurisdiction over Internet-bound traffic upon the FCC.

If enacted into law, HR 4445 would seriously undermine the development of local competition and would interfere with the normal functioning of the competitive marketplace. HR 4445 would provide nothing short of a "bail-out" for incumbent local telephone companies' poor business judgments that resulted in a loss of business to competitors. Specifically, in negotiating interconnection agreements with CLECs and in establishing rates for reciprocal compensation for the exchange of local traffic, incumbent local telcos failed entirely to recognize that the excessive, above-cost prices that they sought to impose upon competitors would work to encourage those same competitors to adopt business plans under which the competitors would be net recipients of inter-carrier traffic.

HR 4445 would, perhaps for the very first time, introduce government involvement in the *content* of lawful private telephonic communications between individual citizens and companies with which they do business — ISPs in this case. Under HR 4445, the very same type of telephone call would be subject to dramatically different rate and competitive market conditions based upon whether it is carrying ordinary voice communication or data communication bound for the Internet. Content-based ratemaking and content-based market organization is an area from which the Congress should distance itself as far as possible.

Finally, the effect of HR 4445 would be to literally put many competitive local telecommunications providers, who collectively have invested hundreds of millions of dollars in constructing facilities-based competitive networks, *out of business*, with the services these companies are presently supplying being handed, as it were, on a silver platter to the incumbent telcos. That a substantial portion (but by no means all) of the business of completing Internet-bound telephone calls has been captured by CLECs is a demonstration of the success of the Telecommunications Act of 1996 in stimulating the development of an effectively competitive market. It would be a most unfortunate step for Congress to now intervene to protect the incumbent monopolies from these competitive losses.

The Telecommunications Act of 1996

The story of reciprocal compensation begins with the Telecommunications Act of 1996 ("1996 Act"). The overarching goal of the 1996 Act is to bring greater competition to the local telephone market which, in turn, will lead to lower prices and increased services for consumers. The 1996 Act attempts to eliminate the last bottleneck in telecommunications services. This bottleneck is commonly called the "local loop," the connection from the home or business to the local switch, where calls are routed to their final destinations.

Local monopolies such as Bell Atlantic and SBC have controlled the local loop for 100 years. The 1996 Act establishes rules by which the regional telephone monopolies have to open up their networks so that competitors can interconnect and offer comparable services to local subscribers. In exchange for opening their networks, the Bell companies would be allowed to provide long distance service, which they have been forbidden to do since the 1984 consent decree that broke up the vertically-integrated Bell System, which had controlled both local and long distance networks.

The 1996 Act also establishes basic ground rules that all competing telecommunications carriers must follow to permit open competition. These include obligations to interconnect their networks with one another, and to pay each other "reciprocal compensation" for traffic carried from one carrier's network onto another's.

While the Federal Communications Commission ("FCC") set the overarching rules to provide for interconnection and local competition, state utility commissions oversee the implementation of these interconnections by arbitration and review of interconnection agreements. This is one of several ways in which the 1996 Act changes the previous, almost hermetic division of responsibility between interstate matters (previously handled exclusively by the FCC) and intrastate matters (previously handled exclusively by state regulators).

What is reciprocal compensation?

Reciprocal compensation is a settlement mechanism for telephone traffic transferred between two local networks. Take an old-fashioned railroad network as an analogy: for the Pennsylvania Railroad to ship a customer's freight to Santa Fe, it had to deliver its traffic to the Santa Fe Railroad for the last leg of the shipment, via interconnecting networks and railroad carriers in between; to do so, PRR needed to have a mechanism for handing off traffic and giving or getting compensation for traffic handed off. The same need to exchange traffic exists at the local level in telecommunications. Recognizing that there can never be true competition for local telephone service if carriers did not pay each other for carrying and terminating calls on their respective networks, the 1996 Act *requires* that local carriers enter into such arrangements.

When a customer places ('originates") a telephone call via an incumbent local telephone company (for example, Bell Atlantic), the customer pays the phone company a fee for handling the call. (Sometimes the fee is in the form of a per-call charge, and sometimes it is in the form of a "flat" monthly usage charge. Either way, the phone company that originates the call receives revenue from its customer as compensation for the entire call, *i.e.*, from the originating caller to the ultimate called number.) If the call goes from, for example, the Bell Atlantic system to a competing local telephone company ("Competitive Local Exchange Carrier" or "CLEC"), and then to an ISP customer (where the call is said to "terminate"), the CLEC incurs a cost for terminating that call to the ISP but receives no direct revenue from the individual who originated the call, since all of that revenue would have been collected by Bell Atlantic (in this example).

Consider, by contrast, a situation where both the customer making the call and the ISP are served by Bell Atlantic. In that case, *Bell Atlantic would have directly incurred the total cost of terminating the call.* Thus, when a CLEC terminates a call, Bell Atlantic *avoids* costs that it would otherwise incur (see Figure 1). "Reciprocal compensation" refers to the payment Bell Atlantic would make to the CLEC for the work the CLEC performs in terminating the call — work that Bell Atlantic avoids.

The same situation exists with respect to regular, non-ISP telephone calls. The customer originating the call pays Bell Atlantic for the entire call, *i.e.*, for both the origination and termination functions. If a CLEC terminates calls placed by Bell Atlantic customers, Bell Atlantic compensates the CLEC out of the total revenues it received from the originating callers for the call termination service that the CLEC provides, and in that way *shares* its revenue with the connecting carrier, just as the railroads or airlines share the total revenue for a transportation service that involves more than one carrier. Conversely, if Bell Atlantic terminates a call placed by a CLEC customer, the CLEC pays Bell Atlantic for that service (see Figure 2).

Under the proposed legislation, Bell Atlantic and its sister incumbent local telcos would escape the obligation to share the revenues they collect from the originating caller with the carrier that terminates the call. Consider this analogy: If I buy a ticket from Washington, DC to, say, Portland, Oregon via United Airlines to Chicago connecting to American Airlines to Portland, the ticket will be issued by United (the originating carrier) and I will pay United the entire price for the ticket. United, in turn, will pay over a portion of the total fare to American for the Chicago-Portland segment. What if Congress were to legislate away American's right to a portion of that multi-carrier airline ticket revenue? Clearly, American would have no reason to accept the United-issued ticket, and would not provide connecting service to the passenger. Yet that is precisely what this legislation would achieve with respect to local telephone service. Why would a CLEC continue to provide call termination services without receiving any compensation for its work? Clearly, it would not.

But the local phone situation is distinguished from the airline example in one critically important respect: Here, the local phone market is overwhelmingly dominated by the incumbent telcos; if the telcos are not required to share their revenues with interconnecting CLECs, the effect will be to put the CLECs out of business altogether and in so doing transfer the ISP business back to the incumbents. *I can think of no better way to eradicate competition in the local phone business than for Congress to enact legislation that would deny entrants the ability to be paid for the work they perform and the services they provide.*

In fact, reciprocal compensation was considered to be important enough as a condition of competition that, in the 1996 Act, Congress made the establishment of "just and reasonable" rates for reciprocal compensation a precondition of a regional Bell company's ability to provide long distance service in its local exchange service territory.

Note that reciprocal compensation need be paid only for terminating "local" telephone traffic. This terminology has been the source of confusion and controversy. There are basically two models for inter-carrier compensation: the "local" model, where two local telcos get a call from the customer of one to a customer of another; and the "long distance" model, where two local telcos get a call from a customer of one to a long distance carrier connected to the other one. In the case of long distance calls, the long distance carrier pays "access charges" to both of the local telcos. The long distance carrier collects revenue from its customer out of which it pays the "access charges" to the local telcos. In the case of local calls, the called party does not pay to receive calls. Whatever legal and regulatory box one chooses to put ISP-bound calls into, in economic terms these calls plainly fall within the "local" model. This is because ISPs are treated as normal business customers, not long distance carriers, when they buy service from a local telco, and calls placed to ISPs by consumers are charged as "local" calls and are subject to whatever "local" rate plan to which the consumers has subscribed.. This treatment of ISPs has contributed significantly to the remarkable growth of the Internet and its contribution to the US economy, and was recently affirmed in legislation approved by this Committee. As long as that rule remains in effect, however, ISP-bound calls, from an economic perspective, are "local" calls, not long distance calls.

What Led to the Current Situation?

The incumbent telephone companies bargained freely for reciprocal compensation in the terms of the contracts (called "interconnection agreements") between themselves and the competing carriers. Under these agreements, the same reciprocal compensation rate would apply for incumbent traffic handed off to CLECs as for CLEC-originated traffic handed off to incumbents. If the traffic flows happened to be equal in both directions, no net payment would be due. However, by adopting explicit reciprocal compensation payments in lieu of the traditional "bill and keep" arrangements that had typified Bell-Independent telco interconnection agreements for decades, the incumbents were expressly providing for the possibility — or even likelihood — that traffic would not be "in balance." Initially, the incumbent telcos believed that, on balance, they would be *receiving* more traffic from CLECs than they would be sending to CLECs for termination, and so insisted upon relatively high reciprocal compensation rate levels. Apparently, however, the incumbents did not consider the possibility that their new rivals would respond to the excessively high reciprocal compensation rate levels imposed upon them by the incumbents by specializing in serving customers with high *inward* calling needs. Such customers might include, among others, taxi dispatch companies, pizza delivery companies, voice mail services, and Internet service providers.

While the incumbents have not (as yet) attempted to disavow any obligation to make reciprocal compensation payments for calls delivered by CLECs to taxi dispatchers and pizza places, they have tried to distinguish calls to ISPs as somehow being different from these other types of calls. They have argued that, even though the FCC has expressly required that calls to ISPs be treated as "local" for rating purposes, ISP-bound calls are jurisdictionally interstate and hence are not eligible for *local* reciprocal compensation payments. Whether incumbent telcos must pay CLECs reciprocal compensation for calls CLECs terminate to ISPs depends upon whether dial-up calls from the end-user to the ISP are "local" or "interstate." Generally, new entrants to the local telephone business contend that calls to ISPs are local traffic and, therefore, subject to reciprocal compensation. Incumbent local telephone companies, on the other hand, generally contend that calls to ISPs are interstate in nature and, therefore, beyond the scope of reciprocal compensation agreements. Of course, CLECs should be entitled to receive payment for their work irrespective of which jurisdiction is involved: incredibly, the incumbents appear to believe that if deemed "interstate" these CLEC services are entitled to no compensation whatsoever, and the incumbents are entitled to keep all of the revenues they received from their customers for calls that are handed off to CLECs for completion.

ISP-bound calls are no different than other local calls

In fact, there is no technical difference between a local call placed to one's next-door neighbor, to a local taxi dispatcher, or to an ISP (see Figures 3 and 4). In all of these cases, the call is physically routed in exactly the same manner by the incumbent telco. If the recipient of the call happens to be a CLEC customer, the incumbent will hand-off the call at a mutually agreed-upon "point of interconnection." The only difference, if any, relates to the *content* of the call, not the process of providing it or the costs involved in so doing. The FCC had attempted to introduce a distinction between "ordinary" and "ISP-bound" local calls under a so-called "one-call" theory wherein the ISP-bound call was deemed to terminate not at the ISP, but instead at some distant web site on the Internet. In fact, even when an Internet user is looking at a particular web site outside of the local jurisdiction, for the overwhelming majority of the time his actual call is being terminated at the local ISP. Direct connection to the Internet occurs only while actual data is being uploaded or downloaded; once the web page is displayed on the computer screen, no actual transmission of data is taking place, *e.g.,* while the user reads the content of the page on the screen.

In any event, the DC Circuit Court of Appeals has soundly rejected the FCC's "one-call" theory — at least as it applies to the reciprocal compensation issue — in a ruling issued this past March. In that decision, the Court expressly found no difference between a call that is delivered by a carrier to an ISP and a call delivered to any other telecommunications-intensive end user business. With the DC Court having now correctly determined that ISP-bound calls physically terminate at the ISP and not somewhere in the Internet "cloud," there is no longer any basis for distinguishing between ISP-bound and other traffic.

In practical terms, it is easy to understand why incumbents would be upset about paying compensation for ISP-bound calls. Their obligation to pay reflects two separate and independent poor business judgments. First, while the 1996 Act requires reciprocal compensation, parties are free to waive that compensation in favor of bill-and-keep arrangements. The incumbents generally refused to agree to bill-and-keep. This business judgment would have been vindicated if CLECs had been unable to compete for and win the business of customers that receive calls; in fact, CLECs were able to do so. Second — and probably more significant in the long run — the incumbents either bargained for, or convinced state regulators to establish, rates for call termination that are well above what most observers would view to be the incumbents' own costs. Again, if the incumbent telcos had been net receivers of traffic, this would have been a good business tactic on their part. But insisting on high call termination rates has the effect of *increasing* the risk to the incumbents of being net *originators* of traffic, just as buying "put" or "call" options on a stock will increase the risk the investor faces from swings in stock price. As more and more states conduct detailed reviews of incumbent telco call termination rates, the rates applicable to ISP-bound calls can be expected to come down over time. The closer that the rate that the incumbent pays the CLEC gets to the costs that the incumbent itself avoids by not having to serve the ISPs, the less of an economic issue this matter becomes.

That said, it is noteworthy that the rates that incumbents have to pay CLECs for delivering calls to ISPs — even the above-cost rates embodied in many of early (and now, generally, expiring) interconnection agreements) — are well below rates that incumbents are happy to *receive* from others for performing identical, or at least closely analogous, functions. Using my home state of Massachusetts as an example, I have prepared a chart (Figure 5) showing that Bell Atlantic receives rates ranging from $0.045/minute (for intraLATA toll) to $0.008/minute (for reciprocal compensation payments from CLECs) when it performs the function of delivering traffic to a particular customer on its network. Yet in the context of calls to ISPs, Bell Atlantic objects to paying $0.008 per minute (the amount included in most of its interconnection agreements) for a CLEC to perform that function, and at present Massachusetts CLECs receive no compensation for terminating ISP-bound traffic.

CLECs that serve ISPs provide a legitimate and necessary service, and have properly responded to pricing signals given them by the incumbent telcos.

In enacting the 1996 legislation, Congress never envisioned that new entrants would be merely miniature clones of the incumbent telcos. Indeed, Congress expressly envisioned that entrants would specialize in serving specific market segments or niches, either geographically or as to the nature of the service involved. Neither Congress nor the incumbent telcos themselves ever envisioned that traffic flows would always be in balance: indeed, the interconnection agreements in almost all cases expressly provided for the treatment of out-of-balance traffic vis explicit reciprocal compensation payments. A number of CLECs found it profitable to specialize in providing services to ISPs, services that in many cases were not even being offered by incumbents. For example, CLECs typically permit ISPs to physically "co-locate" their equipment at the CLEC's central office: no such opportunity is typically offered by incumbent telcos. CLECs have invested hundreds of millions of dollars in specialized switching equipment that is designed to handle large volumes of concentrated inward traffic, whereas incumbents have attempted to serve their ISP customers using conventional telephone switches that are less efficient when dealing with this type of traffic. In short, the competitive market has operated precisely as Congress had intended: It has stimulated entry in areas where new firms could operate more efficiently than their incumbent rivals. It has stimulated the introduction of innovative services that the incumbents had failed or otherwise refused to provide. And it has resulted in consumers having far greater geographically extensive access to the Internet than would have ever been possible had incumbents been the sole source of such connectivity. HR.4445 would instantly reverse all of these gains.

Legislation that would work to deny CLECs compensation for the work they perform would effectively put them out of business and return to the incumbents the business that the incumbents had lost to their competitors. Incumbents do not deserve such protection from the competition that they may face, and legislation that would provide such protection — and in so doing reverse the progress that has been made in achieving a competitive telecommunications market — is fundamentally at odds with the intent of the 1996 Act and, for that matter, of the American free-market system. I urge the Subcommittee to reject HR. 4445 in its entirety.

Thank you for your attention and consideration.

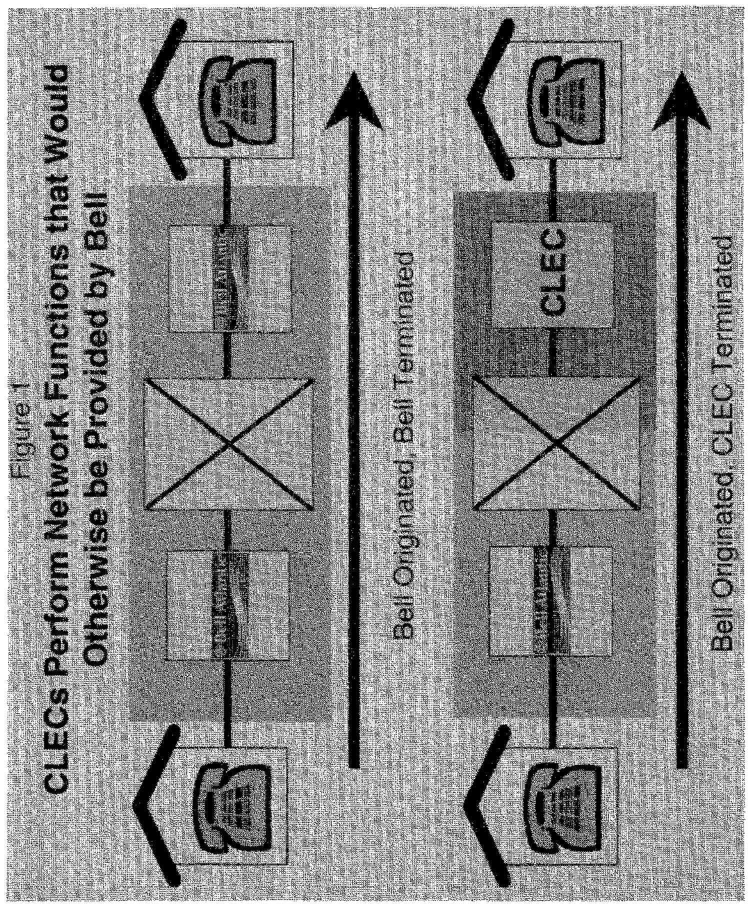


Figure 1
CLECs Perform Network Functions that Would Otherwise be Provided by Bell
Bell Originated, Bell Terminated
CLEC
Bell Originated, CLEC Terminated

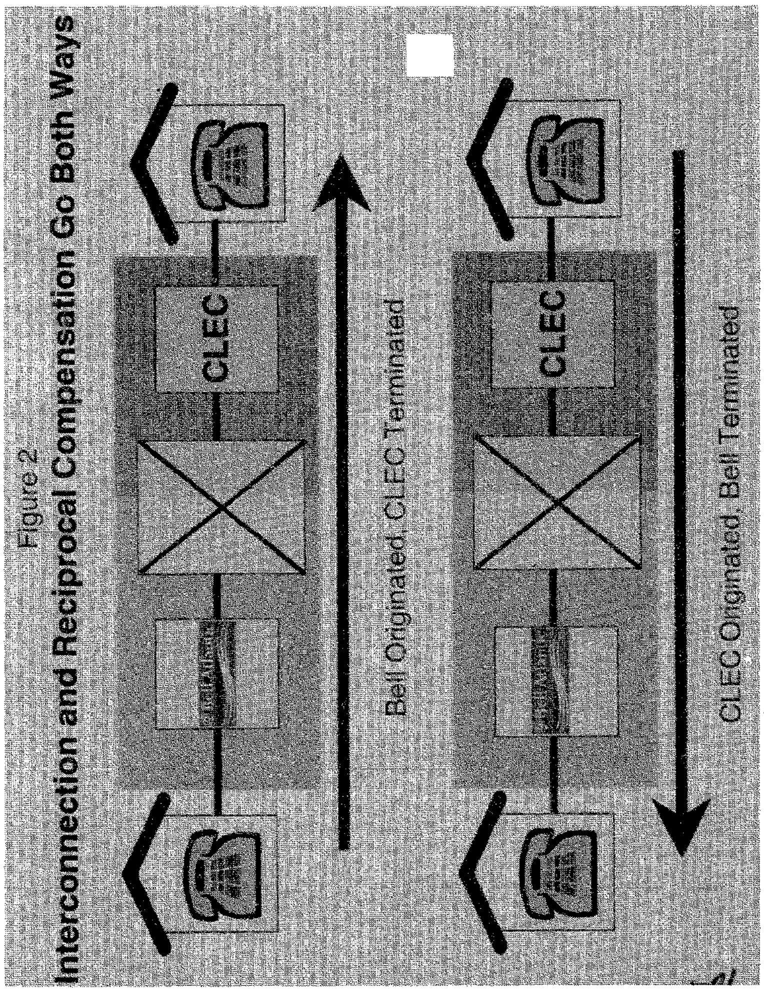


Figure 2
Interconnection and Reciprocal Compensation Go Both Ways
CLEC
Bell Originated, CLEC Terminated
CLEC
CLEC Originated, Bell Terminated

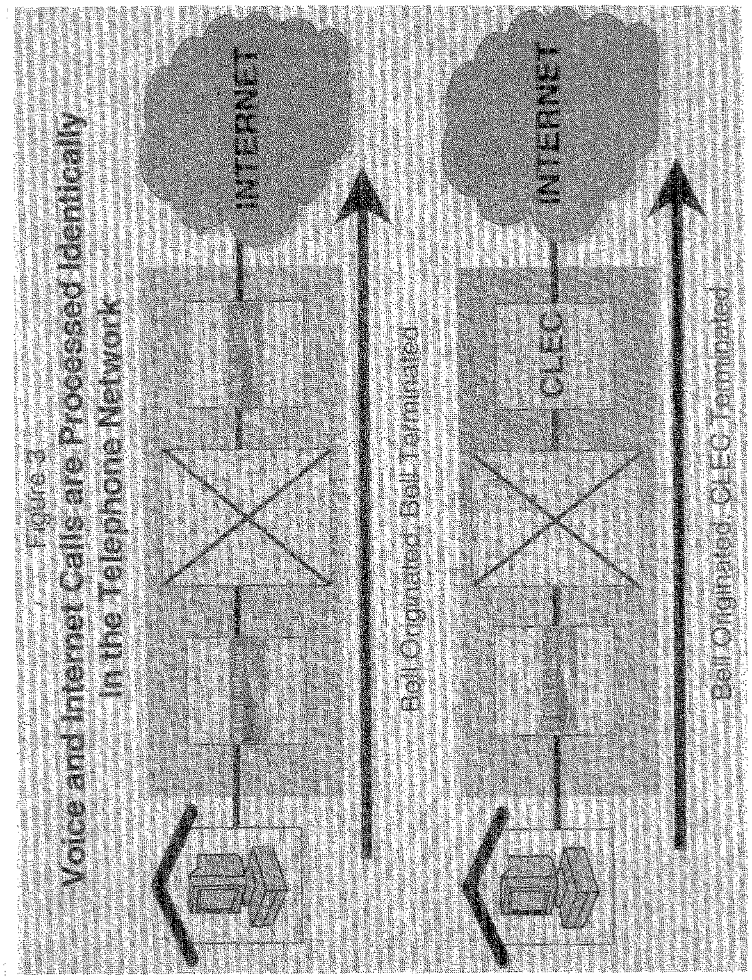


Figure 3
Voice and Internet Calls are Processed Identically
In the Telephone Network
INTERNET
Bell Originated, Bell Terminated
CLEC
INTERNET
Bell Originated, CLEC Terminated

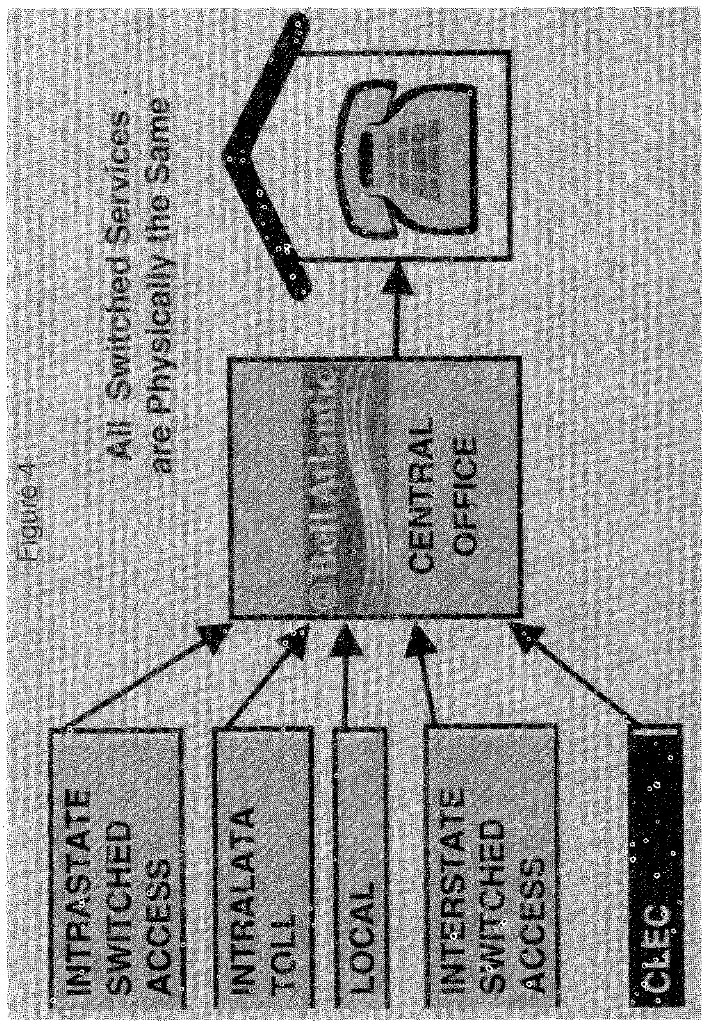
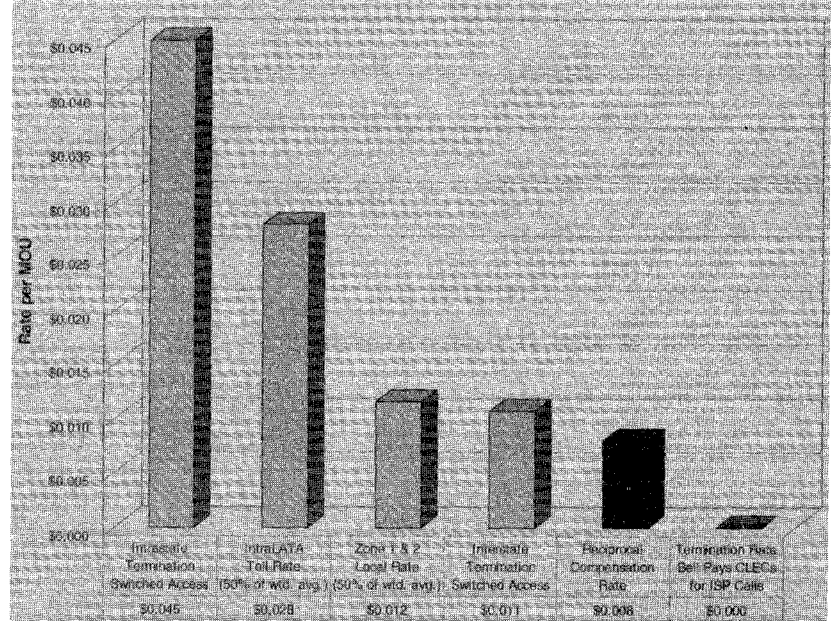


Figure 4
All Switched Services
are Physically the Same
INTRASTATE SWITCHED ACCESS
INTRALATA TOLL
LOCAL
INTERSTATE SWITCHED ACCESS
CLEC
CENTRAL OFFICE

Figure 5

Comparison of Rates for Terminating Traffic in Massachusetts



Sources: BA FCC #1, NEI DPU #15, MA DTE 98-38, BA-MA Response to RR-TC-3, dated March 10, 1999